DEVELOPMENT FINANCING 2000

A Foresight and Policy Study of the Multilateral Development Banks

A Foresight and Policy Study of the Multilateral Development Banks

Study 2000:2

REGERINGSKANSLIET

Ministry for Foreign Affairs

A Foresight and Policy Study of the Multilateral Development Banks

Prepared for the Ministry for Foreign Affairs, Sweden

by

The Institute of Development Studies
at the University of Sussex

Institute of Development Studies
Sussex

For further information about the project *Development Financing 2000* please go to www.utrikes.regeringen.se or contact:

Kåre Pugerup
Project Director
Development Financing 2000
Department for International Development Cooperation
Ministry for Foreign Affairs
S-103 39 Stockholm
Sweden
Fax +46-8-723 11 76
Phone: +46-8-405 10 00
Email: kare.pugerup@foreign.ministry.se

The study can be ordered from:

Fritzes Kundservice
S-106 47 Stockholm
Sweden
Fax: +46-8-690 91 91
Phone: +46-8-690 91 90
Email: fritzes.order@liber.se
www.fritzes.se

ISBN: 91-7496-232-9

Printed by: Bulls Tryckeri AB, 2001

PREFACE

This report represents the culmination of some twelve weeks of exceedingly intensive work by the research team at the Institute of Development Studies (IDS). The magnitude of the tasks and the complexity of the issues set out in the Terms of Reference posed a daunting research challenge within the time frame allocated to this project. Completion of the work would not have been possible without the strong, consistent and willing support we received from the Ministry for Foreign Affairs of Sweden, from many Executive Directors and their staff in the Multilateral Development banks (MDBs), from the management and staff of the MDBs we visited, and from many experts and academics we interviewed. We wish to express our deep appreciation to all of them. While we have attempted faithfully to capture and reflect the richness of the assessments and suggestions we received, the views expressed in this report are entirely those of its authors. We are also grateful to Catherine Gwin and Barrie Hudson, who provided detailed and most useful comments on the draft report, and to the participants in the seminar ‘Financing the Multilateral System’ held in Stockholm on August 31, 2000 and organized by the Ministry for Foreign Affairs of Sweden.

The IDS MDB team was led by Keith Bezanson, and the research was conducted by Francisco Sagasti, Silvia Charpentier and Ricardo Gottschalk, with the assistance of Ursula Casabonne and Fernando Prada. Hans Singer, Stephany Griffith-Jones and Howard White provided advice, comments and suggestions. Jill Clements and Diane Frazer-Smith provided operational and administrative support.

Institute of Development Studies
University of Sussex
October 2000

FOREWORD

The Swedish Ministry for Foreign Affairs initiated the project *Development Finance 2000* with the purpose to increase awareness, knowledge and international commitment to a strong, effective and well-funded multilateral system for development. The project covers both the Multilateral Development Banks (MDBs), the UN development agencies and Global Public Goods.

Globalisation and the changing character of development financing forces us to constantly evaluate the future roles and functions of our international organisations. The increasing flow of private capital to developing countries over the last years has raised issues concerning the new roles for the MDBs in the development world. New demands and challenges such as provision of global public goods also put pressure on the use of the limited resources available in the banks. At the same time we see the international development goals yet far from being reached and an increasing need of poverty focus in our common efforts.

In this context we found it timely to conduct this study to provide a broad framework of the key issues affecting the future of the MDBs. We hope it will be a valuable contribution to the ongoing discussion about the international system for development financing.

Gun-Britt Andersson
State Secretary for Development Cooperation, Migration and Asylum Policy

A Foresight and Policy Study of the Multilateral Development Banks

Page

PREFACE

FOREWORD

EXECUTIVE SUMMARY **i - xv**

1. INTRODUCTION **1**

2. THE MULTILATERAL DEVELOPMENT BANKS IN AN EVOLVING CONTEXT **2**

2.1 The origins and evolution of development cooperation 2

2.2 The development system and the international financial system 3

2.3 The nature of multilateral development banks 4

2.4 A changing context for MDB operations 6

2.4.1 A fractured global order 6
2.4.2 Growing heterogeneity of developing countries 9
2.4.3 Questioning development assistance and the role of the MDBs 10

3. THE CHANGING STRUCTURE OF DEVELOPMENT FINANCE **13**

3.1 External finance requirements of developing countries 13

3.1.1 Financing gaps in developing countries 13
3.1.2 Complementary financing for recurrent expenditures 15

3.2 The evolution of financial flows to developing countries 16

3.3 Private sources of development finance 16

3.3.1 Foreign direct investment (FDI) 21
3.3.2 Foreign portfolio investment (FPI) 22
3.3.3 Prospects for private capital flows to developing countries 23

3.4 Official capital flows 26

3.4.1 Aid fatigue and decline in ODA flows 26
3.4.2 Enduring and changing motivations of development assistance 30
3.4.3 The skewed structure of financial flows to developing countries 33

3.5 Other actual and potential sources of development finance 33
3.5.1 Private foundations 34
3.5.2 The Clean Development Mechanism 35
3.5.3 International taxes 36

4. THE MULTILATERAL DEVELOPMENT BANK SYSTEM 38

4.1 Characteristics of and relations between multilateral development banks 38
4.1.1 Some key features of MDBs 38
4.1.2 Interactions between the MDBs 41

4.2 Changing constituencies and multiplicity of MDB stakeholders 44

4.3 Some aspects of the evolving roles of the MDBs 46
4.3.1 Changes in the operations of MDBs 47
4.3.2 The evolution of net transfers and countercyclical lending 47

4.4 Financial vulnerability and capital adequacy of MDBs 52
4.4.1 Regular lending windows 52
4.4.2 Concessional lending windows 54
4.4.3 Private sector lending windows 55

4.5 Sources and uses of net income: their financial and operational implications 55

4.6 The Highly Indebted Poor Countries (HIPC) initiative and its impact on the MDBs 57

5. TOWARDS A FRAMEWORK FOR STRATEGIC CHOICES 64

5.1 The future evolution of the international context and the roles of MDBs 64
5.1.1 A negative scenario 64
5.1.2 A positive scenario 65
5.1.3 Some implications for the MDBs 66

5.2 Maintaining the relevance of the MDBs 67
5.2.1 Visualizing the MDBs as a system 68
5.2.2 The triple role of the MDBs 69

5.3 The product line of the MDBs 70
5.3.1 Financial resource mobilization 70
5.3.2 Graduation, types of borrowers and MDB product differentiation 73
5.3.3 Capacity building, institutional development and knowledge brokering 74
5.3.4 Provision of regional and global public goods 75

5.4 Division of labor and coordination 77

5.5 Capital adequacy of the MDBs and the impact of the HIPC initiative 80

5.6 Relationships with borrowers and income management policies 82

6. CONCLUDING REMARKS 84

ANNEXES 87

Annex A: Additional tables and figures

Table A-1: Classification of developing countries according to the Development Assistance Committee of the OECD 88

Figure A-1: Shares of private flows in total resource flows by region 90

Figure A-2: IBRD, IABD and CAF net transfers to each of the Andean region countries (Bolivia, Colombia, Ecuador, Peru and Venezuela) 93

Annex B: The origins and evolution of the development cooperation experiment 96

Annex C: Development Thinking and Practice During the last Half-Century 101

Annex D: A fractured global order 113

Annex E: Questioning development assistance and the role of the MDBs 122

Annex F: External Financing Needs of Developing Countries 131

Annex G: Developing Countries and Multilateral Development Banks in the Global Financial Architecture 151

Annex H: List of acronyms and abbreviations 156

Annex I: List of definitions related to financial flows 158

Annex J: List of person interviewed 161

SELECTED BIBLIOGRAPHY 165

LIST OF FIGURES

1.	The development system, the international financial system and the Multilateral Development Banks	5
2.	Official flows and private flows to developing countries (US$ Billion)	17
3.	Official flows and private flows as percentage of total net resource flows to developing countries (Percent of total)	17
4.	Concentration of private capital flows, 1990-1998 (US$ Billion)	19
5.	Developing countries: net capital inflow, by region, 1975-1998 (Percentage of aggregate net capital inflow)	19
6.	Total FDI net inflows to developing countries by regions, 1980-1999 (US$ Billion)	22
7.	Net Official Development Assistance flows from DAC countries, 1990-1998	27
8.	Net ODA in 1998-as percentage of GNP	27
9.	Official net resource flows dependency by region, 1980-1999 (percentage of GNP)	28
10.	Concessional disbursements by region, 1980-1999	29
11.	Concessional disbursements as counter-cyclical to reductions in growth rates in low-income countries, 1971-1999	30
12.	ODA Bilateral grant flows for specific purposes, 1982-1998 (US$ Million)	31
13.	Multilateral official flows as percentage of total net financial flows to developing countries (percentage)	39
14.	Total Net Transfers of IBRD and Regional Banks to developing countries (US$ million)	48
15.	Multilateral Development Bank Net Transfer to developing countries by regions (US $ million)	49
16.	Total net transfers of IBRD, IADB and CAF to Andean countries, 1990-1998 (US$ million)	52
17.	International Bank for Reconstruction and Development: Uses of net income (US$ millions)	58
18.	African Development Bank: Uses of net income (US$ millions)	58
19.	HIPC Debt initiative	60
20.	The triple role of the Multilateral Development Banks	69

LIST OF TABLES

1. The family of Multilateral Development Banks 8
2. Net external financing needs of developing countries, by Region (annual averages) 14
3. Distribution of net long term private capital flows to developing countries, 1990-1999 (US$ Billion) 20
4. Main economic determinants of different types of direct foreign investment 21
5. Sovereign ratings for developing countries (above BB+ rating) 25
6. Motivations for Official Development Assistance 32
7. Financial Indicators of Multilateral Development Banks, 1999 (US$ millions) 40
8. Comparative MDB loan charges 42
9. Administrative Costs and Performance Indicators for Selected MDBs, 1995-1999 43
10. An illustrative list of MDB stakeholders and constituencies 45
11. Voting Power and Membership of the Main MDB Shareholders (Countries participating in three or more MDBs and Russia) 46
12. Risk-bearing capital ratios for selected MDBs 54
13. HIPC Initiative: Estimates of Potential Costs by Creditor (US$ billion in 1999 Net Present Value terms) 61
14. MDB roles in a positive and a negative international context for development 67
15. Division of labor between MDBs and other institutions in the development and the international financial systems 79

LIST OF BOXES

1. The traditional model of a Multilateral Development Bank: A preferred creditor with sovereign borrowers 7
2. The Global Alliance for Vaccines and Immunization 33
3. Commodities price stabilization: a new approach at the World Bank 35
4. Resources for the Fund for Special Operations (FSO) at the Inter-American Development Bank 56
5. Some key features of the Poverty Reduction Strategy Papers 63
6. The World Bank and the provision of public goods 76

EXECUTIVE SUMMARY

(i) The present study attempts to provide a broad strategic framework for examination of issues affecting the future of the Multilateral Development Banks (MDBs). It is based on a review of the extensive and growing literature on the subject, on research conducted by the members of the IDS team, and on interviews with senior MDB staff members, government officials and policy makers, financial sector experts and researchers.

(ii) The range of membership in the research team reflected multiple, prior experiences with MDBs. Some had held senior policy positions within MDBs; one had been an Executive Director on the Board of Directors of the World Bank; and two had negotiated policies and loans with MDBs on behalf of their countries. These diverse experiences and perspectives proved exceedingly valuable in carrying out this investigation.

(iii) The conduct of this study has been compressed into an exceedingly short period of time, especially considering the magnitude of the task and the diversity of institutions and issues to be covered. The team did hold first-hand discussions in all of the major MDBs and interviewed dozens of senior policy-makers, but time and resource limitations prevented extensive, direct consultations with bilateral users of MDB services and products or with the sub-regional banks that are also a factor in multilateral development co-operation. These represent gaps in this study and an important piece of unfinished business that we would hope might be addressed in follow-up work to this report.

MDBs: Current Pressures and Paradoxes

(iv) This is a time of unprecedented stress on the entire MDB system. At no time since the founding of the World Bank over fifty years ago have multilateral institutions been forced to contend with so many pressures and paradoxes. They are challenged as never before by their poorer member countries to help catalyse successful integration into the global economy and, at the same time, to help alleviate the deep socio-economic fissures that such integration can also cause. New levels of openness and transparency are demanded over the full range of MDB operations, while the institutions remain bound in many instances to protect the confidentiality of privileged relationships with clients. They are asked to exercise regional and global leadership by uniting international development efforts and also to reflect the myriad interests, differing viewpoints, and often-conflicting priorities of a vast array of other actors. They are required to seek out and function effectively in partnerships with governments, decentralised authorities, the private sector, bilateral and other multilateral agencies and NGOs, and to do so at national, trans-national and grass roots levels. They are instructed to decentralise and increase operational strengths on ‘the ground’ while demonstrating increases in parsimony and savings in administrative costs. They are confronted with angry mobs calling for their abolition; with accusations of expansionism ('mission creep'); with pleas for expanded roles in human rights and 'good governance'; and with very public reports (such as the Meltzer Report) urging radical changes, greater role differentiation and much higher levels of specialisation.

(v) These are only some of the current pressures and paradoxes being experienced by the MDBs. Recognition of the magnitude of these factors was clearly provided in the World Bank's 1997 launch of its Strategic Compact. The stated goal of the Compact was nothing less than a dramatic transformation of the institution in recognition of the new pressures and to contend with the new paradoxes. Similar recognition and similar efforts at fundamental transformation have since become evident in all of the MDBs.

A changing context for development, finance and the MDBs

(vi) These factors and forces are by no means exclusive to the MDBs, but rather are components of much larger changes to the entire *international development system,* to its foundations and to the context of its efforts. Today's organizations concerned with improving the quality of life and reducing poverty in developing regions, whether primarily local or global in emphasis, are engaged in a new dynamic that pulls simultaneously in two directions: towards collaboration and towards conflict. As never before in its fifty-year history, the *international development system* is now bringing together the state, the private sector and civil society in complex and myriad interactions that will determine the success or failure of future development efforts.

(vii) But MDBs are not only central to the international development system, they are also leading participants in an *international financial system* which has grown explosively during the last three decades. The broad field of *development finance* is located at the cusp of these two systems (the *international development system* and the *international financial system*), and it is here that the uniqueness of the MDBs is defined. While a diversity of institutions is located at this cusp (e.g. bilateral assistance agencies, private foundations and private investors), the *MDBs are uniquely placed, for more than all other organizations, they interact with all entities that straddle the worlds of development and of international finance*.

(viii) Yet while it is conceptually useful to describe the MDBs as a 'family' of institutions, they are in practice (and as shown in this report) vastly different organizations. They differ greatly in core capabilities, institutional cultures, governance and accountabilities. There are major obstacles to bringing about improved co-ordination among them, let alone a functional division of labor. To speak more broadly in terms of an 'international development family' is to confront an infinitely greater range of differences and obstacles to improved co-ordination.

(ix) Those who seek improved co-ordination among the MDBs and between them and other members of the international development system (and most major donors do seek this) will need to change their own practices if this is to succeed. They will need to move their policy and practice focus away from its dominant pattern of dealing with single organisations and discrete channels of delivery and move to more systemic approaches that visualise the totality of the systems of international development and international finance. Donors have been quick to call for greater development co-ordination, but exceedingly slow in recognising the high transaction costs involved in moving to more co-ordinated country programs. They have similarly been quick in demanding that the MDBs (especially the World Bank) take active leadership in promoting effective partnerships and co-ordinated efforts, but little account seems to have been taken of the considerable increase in administrative and professional resources that this requires.

Multilateral Development Banks: A definition

Multilateral Development Banks are international financial intermediaries whose shareholders include both borrowing developing countries and donor developed countries. They mobilize resources from private capital markets and from official sources to make loans to developing countries on better than market terms; they provide technical assistance and advice for economic and social development; and they also provide a range of complementary services to developing countries and to the international development community.

Their product lines include long-term loans at below market rates of interest, concessional loans at very low rates of interest and long repayment periods, guarantees to enhance private investment, and relatively small amounts of grant financing, mostly for technical assistance, training and capacity building in borrowing countries. Most MDBs fund their long-term loan operations through borrowings in the international capital markets, whereas concessional loans and small grants are funded through contributions by donors (also called replenishments) and from the MDBs net income.

MDBs have a *preferred creditor* status in relation to private lenders, deriving in considerable measure from their low gearing ratios in comparison with private financial institutions. As a result, MDBs enjoy high ratings from bond rating agencies, which allows them to raise funds on favorable terms in the international capital markets. They mostly provide loans directly to governments or to public institutions with government guarantees, even though private sector operations - done directly or through their private sector affiliates - have become increasingly important for some of them. About two dozen international institutions qualify according to this broad definition of an MDB.

(x) *The MDB model is a most useful institutional innovation to assist developing countries.* In spite of many problems and shortcomings, independent analyses have consistently confirmed a reasonably positive track record and the fact that there are no other institutions that provide a comparable range of products and services to member countries. With the possible exception of similar organizations that would benefit from automatic resource mobilization mechanisms (e.g. international taxes), there are no alternative institutional innovations in sight that could provide the combination of financial resource mobilization, capacity building and institutional development, knowledge brokering and the provision of international public goods.

(xi) The *MDBs* have consistently evolved and changed over the past half century, but as already indicated they *are currently experiencing unprecedented transformation.* This involves, *inter alia*:

- The emergence of a fractured global order (which implies a fundamental shift in international power relations, financial globalization, among other changes).
- A more diverse set of borrowing shareholders and clients, necessitating a broadening of their range of products and services.

- A growing number of more active and vocal stakeholders that forcefully press their interests on MDB management and shareholders.
- Expanding and conflicting demands, which are stretching response capacities and may lower the quality of operations.
- Accumulated management and administration problems, often the product of incremental adaptations and operational mistakes.
- An avalanche of criticisms and attacks from both left and right.

(xii) These factors create great pressures of a discontinuous nature and must be expected to produce a climate of uncertainties both about the future of the institutions themselves and within the individual institutions themselves. By contrast, however, there are some reasonable certainties at least in the foreseeable future of development finance. These would include:

- *Developing country financing demands will continue to be very large*. There is no prospect of achieving reasonable rates of growth to reduce poverty without major increases in investment. Domestic savings for much of the world are simply insufficient to finance investment levels that would lead to sustainable poverty reduction.
- *Private financing has grown significantly, but not in a way that suits most developing countries* (high concentration of foreign direct and portfolio investment, volatility, limited and uncertain developing country access to capital markets).
- *Official Development Assistance is stagnating*. Fiscal constraints have given way to political constraints in key donor countries. Although encouraging, newcomers to the concessional finance scene will not significantly change this situation. There is certainly need for a renewed national security argument to support ODA in the post Cold War era, but there are few signs that would suggest early dividends from such arguments.
- *New forms of development finance* (e.g. Clean Development Mechanism, international taxes) could become important in the medium-run and *private foundations* may expand their assistance to developing countries in a highly focused and selective way. Such new forms, however, are both too uncertain and too limited to be depended upon to spur development in poor countries.
- Therefore, *MDBs will continue to be needed to provide finance and a range of complementary services and products to developing countries for many years to come.*

The MDB system

(xiii) Of the two dozen institutions that are classified as MDBs, a relatively small number (i.e. the World Bank Group and the four regional development banks) are regarded as major players in international development finance. However, several sub-regional banks are growing in importance for their developing country members (e.g. Andean Finance Corporation, Arab Fund for Economic and Social Development).

(xiv) The percentage of total net resource flows to developing countries accounted for by the major MDBs has varied between 5 and 20 percent during the last thirty years and is now at about 7 percent. The peak occurred in the mid-1980s, as the MDBs stepped in to compensate for the abrupt fall in private flows due to the debt crisis. While the MDB share in total net resource flows to developing countries appears relatively small, its impact is much greater, primarily because it mobilizes complementary domestic and international resources, and involves policy dialogue, conditionality and technical assistance - which spill over beyond specific loan operations.

(xv) The historical nature of institutional relations between MDBs has been complex and contradictory, involving a combination of cooperation, rivalry and competition, particularly in the field. While there have been a number of formal inter-institutional co-operation agreements, including cases where specific divisions of labour have been agreed, there has also been (and continues to be) competition for bankable projects, particularly in the smaller countries where the number of such projects may be limited.

(xvi) The traditional MDB constituencies have been - in addition to member governments - groups and individuals concerned with Cold War containment, private businesses seeking procurement and/or contracts in public works, and groups concerned with improving the quality of life for the poor. The end of the Cold War has eliminated much of the national security constituency; and the transition to policy based lending, privatization and competitive bidding for public works has diminished the relative importance of MDBs to private firms. Apart from shareholders, therefore, the constituency trend for MDBs is towards just one of its traditional constituencies: those with a professional or personal interest in development.

(xvii) MDBs are owned by and must respond to the expressed interests of their member-governments. But here, too, important changes are occurring. The perceptions of many shareholders - as well as those of management - are being influenced increasingly by domestic constituencies, particularly in the non-borrowing countries, and by a growing multiplicity of stakeholders. Each group of stakeholders tends to express its views and requirements in a variety of ways, in different manners and through a diversity of channels, generating a cacophony of demands that must be paid attention to and sorted out, seeking to balance conflicting interests. However, in spite of the growing differentiation of stakeholders, the member-governments as shareholders remain pre-eminent in shaping the future of the MDBs and in determining their main accountabilities.

(xviii) In parallel with a host of reforms pressed on United Nations bodies by member governments, during the last decade shareholders have also sought to introduce major institutional reforms in the MDBs. However, there are indications of a growing ‘reform fatigue’ in United Nations agencies and in the MDBs. The issues involved here are quite complex, but both anecdotal evidence and research suggest the emergence of genuine concerns about whether the reforms are owned within the organisations and accepted by many of the country members. Concerns are also voiced about whether the costs of ‘downsizing’ and ‘rightsizing’ - and of decentralisation and of ‘streamlining’ administrative structures - will result in new and excessive costs being passed on to borrowers.

(xix) The importance of MDBs declines for borrowing countries that succeed in increasing their living standards, improving their economies and gaining direct access to private capital markets. At the same time, this transition usually means that such countries move from a relationship involving a positive net financial transfer with MDBs to one that is negative over many years as loans obtained earlier are repaid. Economic growth and poverty reduction, however, are far from being entirely synonymous, and for developing countries unable to grow and reduce poverty in a sustained manner, negative net transfers pose serious problems. This has led to the argument that MDB portfolios should grow steadily to maintain positive net transfers: meeting shareholder expectations with respect to poverty reduction is seen as inconsistent with negative net disbursements. An alternative perspective would view the net transfer situation of the MDB system as a whole and region by region. As the portfolio of one MDB matures and moves into lower positive transfers or into negative net transfers with a group of countries, other MDBs would move to a positive net transfer situation to compensate for it. For example, as the World Bank has reduced its positive net transfers globally and to the various regions, the regional development banks have increased theirs. This may also bear on at least some of the sub-regional MDBs. For example, the Andean Finance Corporation (CAF) is currently in a larger positive net transfer situation with Andean region countries than either the Inter-American Development Bank or the World Bank.

(xx) Currently and for the foreseeable future, MDBs will be pressed to perform a triple role:

- Financial resource mobilization;
- Capacity building, institutional development and knowledge brokering;
- Provision of global and regional public goods.

An adequate capital and financing structure is fundamental if MDBs are to fulfil satisfactorily this triple role. Yet as pressures mount on MDBs to respond to increasing demands for global and regional public goods they must be careful to maintain their resource mobilization capabilities that have made them one of the most successful institutional innovations of the 20th century. *This requires simultaneously the maintaining of the political support of shareholders* and *consistently achieving good financial ratios* (especially in relation to risk-bearing capital). Both of these are necessary if capital markets and donor countries are to continue to view MDBs as viable financial intermediaries.

Managing Risk and Vulnerabilities

(xxi) Sources of risk and vulnerability are different in regular, concessional and private operations.

- For <u>regular lending windows</u>, there are three interrelated sources of risk: (i) *political*, which refers to the relevance of MDBs to their shareholders and the support they receive from them; (ii) *market*, which refers to the ability to raise funds in capital markets at low cost; and (iii) *portfolio*, which refers to the concentration and quality of the loans, as well as to the impact of global financial shocks and contagion effects.
- For <u>concessional lending windows</u>, there are two sources of risk: (i) *political*, which refers to the support of donor countries; and (ii) *portfolio*, which refers to the ability of borrowers to pay the loans back.
- For <u>private sector lending</u> there are two sources of risk: (i) *market*, which refers to the ability to raise funds in capital markets on appropriate terms; and (ii) *portfolio*,

which refers to the performance of their investment projects and of their equity holdings in private firms.

These risks cannot be managed effectively without the maintenance of strong financial positions and the bolstering of risk-bearing capacity. In more concrete terms, this requires a solid capital base and robust operating and net income levels, which would allow for increases in equity (paid-in capital plus reserves). Other options are often suggested, including measures to reduce the cost of borrowing, assuming higher risks in managing liquidity, loan securitization, and improved management of administrative expenses. These could help, but only in relatively modest ways. The irreducible keys to effective risk management in MDBs lie in the combination of a strong capital base and solid and sustainable operating and net income levels.

(xxii) Given these factors, it is not surprising that the growing and conflicting pressures faced by MDBs find clear expression in the *management of their income*. Achieving an appropriate balance between the three main functions of MDBs involves difficult decisions on the size and the allocation of operating and net income. First, there is the need to use net income to *increase reserves and strengthen their financial position and risk-bearing capacity*. Second, a shift to more complex operations and engagements with stakeholders requires more and better trained staff, as well as a larger presence in the field, both of which *increase administrative expenses* and reduce the margin for net income. Third, a portion of net income is needed to make *transfers to concessional loan windows* and to *provide grants* for public goods and special operations such as emergency relief (which also increase administrative costs). Finally, some MDBs will face new challenges as a result of *the assignment of significant amounts of net income to cover part of the costs of their participation in the Highly Indebted Poor Country* (HIPC) initiative.

Income from loans can be raised either by increasing the lending volume or by increasing loan charges. Without adequate safeguards, both measures could lead to a deterioration of the loan portfolio. Increasing the lending volume could prove imprudent while increasing the charges could make MDB lending non-competitive (in countries with access to capital markets and especially when transaction costs to borrowers are factored in). In addition, i*ncome from the management of liquid assets* can be raised by increasing the resources at the disposal of the MDB for short-term investment in capital markets, and by assuming higher market risks. However, this source of income is rather volatile and subject to capital market swings, which makes it unreliable so that it cannot be counted upon at a time of international financial crisis, when it would be most needed.

The Enhanced HIPC Initiative

(xxiii) The enhanced HIPC initiative aims to provide broad, deep and fast debt relief for the poorest countries. However, even though efforts are being made to link debt relief with sustainable poverty reduction programs in recipient countries, doubts are emerging about the quality and sustainability of post-HIPC growth and poverty reduction efforts. *The cost of HIPC is estimated at US $28.2 billion in 1999 net present value terms, about 40 percent (roughly US 11 billion) of which corresponds to multilateral creditor*s. This has important financial implications for some MDBs (especially IDA: US $5.7 billion; African Development Bank: US$ 2.2 billion; Central American Bank for Economic Integration: US$ 390 million; Arab Bank for Economic Development in Africa: US$ 180 million). As of mid-2000 pledges to the MDB HIPC Trust Fund added to about US$ 2.4 billion, less than a quarter of the required amount.

Whereas debt reduction can be achieved at the stroke of a pen, making use of the opportunities it creates for economic and social development requires time, financial resources and the capacity to design and implement development programs. Donors, including MDBs, are agreed that the preparation of Poverty Reduction Strategy Papers (PRSPs) is key to linking debt reduction to development. Thus, PRSPs are prerequisite to obtaining debt relief under the HIPC initiative. The intent for PRSPs is that they should be carefully designed with significant involvement of all segments of society, should be 'owned' by developing countries, should be analytically sound and practical, and should provide a framework for all donors to work together. This is the current theory linking HIPC to development effectiveness.

In practice, however, (and in addition to a large potential funding gap) several major problems are emerging that threaten the initiative and that hold serious implications for MDBs. First, PRSPs are viewed by many as dominated by the World Bank and the IMF. Secondly, there are great time pressures: countries want to benefit from debt relief as soon as possible and the financial institutions want to be seen as taking swift action. Thirdly, there is considerable concern in at least some MDBs that the PRSPs may tend to substitute direct social expenditures for investments in the economic infrastructure essential to private investment, employment creation and economic growth. Fourthly (and related to the third point) is a worry that PRSPs may push several MDBs (and the IMF) away from their core competencies in macroeconomic stabilization and support to essential economic infrastructure and through 'mission creep' into areas of development in which they have neither experience nor competence. The longer term implications of HIPC and PRSP for at least several of the MDBs are considerable. In addition, PRSPs may end up being a casualty of hasty implementation and the Achilles heel of the HIPC process.

Towards a framework for strategic choices

(xxiv) In order better to examine the roles that the MDB family of institutions could play at the fast-changing intersection of the development and international finance systems two extreme situations have been visualized (see Section 5.1). The first scenario is exceedingly negative, in which the world economy moves perilously close to global deflation and which carries, of course, severe implications for developing countries. The second scenario posits the continuation of a robust world economy with only minor fluctuations around a high-growth trend. An examination of the requirements, consequences, demands and implications of both these extreme scenarios (and for any intermediate ones) suggests that, for the foreseeable future, there *is a clear need for the multilateral development banks and for the important role that they play*. While there are other institutions that also work at the intersection between the development and the international financial systems, none can furnish the combination of products and services that the MDB family of institutions is capable of providing to its member countries.

(xxv) *This does not imply, however, a 'business as usual' approach. To maintain their relevance to a growing diversity of stakeholders, and to their shareholders in particular, MDBs will need to articulate multiple strategies to respond to disparate, conflicting and shifting demands.* Such strategies, in the first instance, must be directed at maintaining and increasing political support from <u>all</u> their shareholders (i.e. not only from the most powerful ones). In turn, this implies having the capacity to respond to the continuously changing demands of a more diverse set of shareholders. Without ensuring that they can adequately respond to the shifting needs, demands and perceptions of its shareholders, it is unlikely that the MDBs will be able to respond with consistency and coherence to the explosion of new demands coming from other sources. Included here are international organizations, bilateral development agencies, financial markets, private firms and corporations, academic and policy-making institutions, non-governmental organizations and MDB staff.

Each multilateral development bank has a different set of constituencies to which it is accountable. However, what may be described as the different 'personalities' of the MDBs should not prevent visualizing them in an integral manner, as a set of organizations that share common characteristics, play similar roles and conform broadly to the same institutional model. Approaching the family of MDBs as a whole will require a shift in perspective on the part of member governments and MDB management. The dominant practice of focussing on the World Bank, and occasionally on one or another regional development bank, will need to move to *more systemic approaches* that visualize the totality of these institutions as they relate to their shareholders and other stakeholders. *The challenge is to transform a more or less disparate family of institutions into a more efficient network and eventually into an effective MDB system.*

(xxvi) Such systemic approaches will be essential to ensuring future effectiveness of the *delicate balance between (a) financial resource mobilization; (b) capacity building, institutional development and knowledge brokering; and (c) providing regional and global public goods*. It is increasingly clear that MDBs should not be involved in each of these functions to the same degree, but that the MDB system as a whole (including the sub-regional institutions) needs to ensure adequate coverage of all of them.

There has always been a *fundamental tension between the financing and development roles of the MDBs. This has been exacerbated during the last decade by an increasing emphasis on the public goods function*. In some MDBs (e.g., the Asian Development Bank, the Central American Bank for Economic Integration and, to a lesser extent the World Bank), tensions between financial market mediation (i.e. the financing role), on one hand, and the development and public goods roles, on the other, are at their highest level in years. The impacts of recent financial crises in Asia, Russia and Latin America, of increased volatility in financial markets, and of new demands on the MDBs have combined to create increased pressures for tradeoffs between pursuing one function at the expense of the others. The significant decline in real terms of ODA, for example, has resulted in greater demands on MDBs from both developed and developing member states for increased resource allocations to poverty reduction programs and to public goods. However essential this may be, for *the MDB system as a whole* financial resource mobilization must be considered as '*primus inter pares*' of the functions assigned to these institutions. Providing loans to borrowing member countries is an essential condition for the existence of an MDB, and neither of their other two main functions could be performed without preserving their lending capacity, which in turn requires safeguarding their financial integrity.

(xxvii) This will also require that much sharper differentiation be made between categories of countries and the kinds of MDB engagement that make sense for each of these categories. The current distinction between concessional and non-concessional borrowers is inadequate to meet the needs of the increasingly complex, conflicting and expanding demands on MDB resources. It is also inadequate to distinguish between countries that are eligible for non-concessional loans and those that are not, simply on the basis of rather crude assessment of whether they have access to private capital markets. In addition to the extent of poverty and the degree of access to private capital, issues such as the extent of and commitment to policy reforms, the impact that MDB lending on the sustainability of the reform process, the importance of maintaining policy dialogue, and the need to provide support in the event of a major international financial crisis, should figure among the criteria to determine the categories of MDB borrowers and the types of engagement that make sense.

(xxviii) If the MDBs are to cover their three main functions adequately and maintain shareholder support, they will *need to expand the product line*.

With regard to *financial resource mobilization,* this will require the MDBs to:

- Develop a broader range of products suited to different client needs and priced accordingly (all the way from large, emergency, fast-disbursing loans for middle and high income developing countries, to small, capacity building, slow disbursing loans for poor countries).
- Eschew formal graduation policies, and instead differentiate products aimed at specific segments of borrowers, pricing them according to their characteristics.
- Focus on enhancing other financial flows, both official (co-financing, donor coordination) and private (comfort, guarantees), and on helping to increase domestic resource mobilization (financial sector reforms, public expenditure reviews).

- Explore new forms of mobilizing financial resources for poor countries (trust funds to cover recurrent expenditures, export promotion, debt reduction on an exceptional basis).

With regard to *capacity building, institutional development and knowledge brokering* MDB institutions will need to:

- Ensure the availability of the technical and management capacity to engage in more costly and lengthy operations (social sectors, governance, safety nets, and continuous policy dialogue). Some of the MDBs currently simply do not have these capabilities or do not have them in sufficient quantity and quality.
- Build and renew their intellectual capacity to engage in policy dialogue with stakeholders, embracing intellectual diversity and a greater willingness to learn from others.
- Focus on spreading best practices and on building policy-making capacities in borrowing countries.
- Give greater and special emphasis to technological innovation and scientific research capabilities (bridge the knowledge divide).
- Explore the possibility of charging for non-lending (i.e. technical assistance, information, policy dialogue) services to middle and high-income developing countries.

With regard to the *provision of regional and global public goods* the MDB family of institutions will need to:

- Engage with other regional, international and global organizations in strategic partnerships. The evidence from current practice is that MDBs cannot and should not on their own continue to attempt to provide public goods.
- Ensure they can count on sufficient grant-making resources to cover the cost of contributing to the sustainable provision of public goods.
- Develop jointly with strategic partners rapid-response capacities to help member countries cope with shocks. In addition to the sudden and unforeseen requirements resulting from natural disasters and health epidemics, the benefits of increased economic openness and integration into the global economy also entail increased exposure to volatility.
- Explore new forms of resource mobilization for this purpose (predictable and assured funding, international taxes, international fiscal transfers).

(xxix) The rapid expansion of demand on the MDBs to play a much greater role in the provision of regional and global public goods needs to be further examined in order to arrive at the right balance between this function and direct support to the development of a borrowing country. There are tradeoffs that will need to be addressed, but there are also issues of the comparative advantage of MDBs versus other institutions in the provision of certain public goods. The MDBs should not be placed in the position as last resort provider of global public goods.

(xxx) The division of labor between the MDBs and other development agencies as well as between the MDBs themselves has been a rather vexing question that has persistently dogged these institutions. First, there is the *division of labor between MDBs and private sources of capital*. The argument has recently been re-stated (see the Meltzer Report) that MDB loans produce market distortions by 'crowding out' private investment. There is no credible economic analysis in support of this contention. To the contrary, the assessment provided by major rating agencies and by private investors tends to suggest that MDB loans send signals of market confidence and are inclined, therefore, to 'crowd in' private investment. In addition, even in sectors that attract private financing, loan maturities, conditions for private investment (tax breaks, fiscal incentives) and differences between private and social rates of return may continue to require MDB participation through loans or guarantees.

Second, there is the *division of labor between the MDBs, bilateral agencies, and United Nations and regional organizations in mobilizing concessional financing*, especially for social sectors. This is an area of very rapid change that is moving in paradoxical directions. On the one hand, in the areas of 'soft interventions', which involve primarily setting norms, establishing standards, and providing policy advice, a larger role is emerging for institutions other than the MDBs, including private entities, foundations and non-governmental organizations. This recognizes that the margins for independent action and for agility in policy and in practice are greater for a range of international actors than for the MDBs which must respond first to their complex inter-governmental constituency. On the other hand, the MDBs themselves are at the same time moving increasingly into 'soft interventions' (e.g. micro credit, vaccination, gender, participatory programs, governance, environmental conservation). There is perhaps no more dramatic example of this than the direct involvement of the International Monetary Fund (IMF) in 'participatory approaches' to the preparation of Poverty reduction Strategy Papers (PRSPs) and the renaming of the ESAF as the Poverty Reduction and Growth Facility. This paradox of 'mission creep into soft interventions' by the MDBs and the emerging larger role in the same areas for other organizations is contributing to an increasingly unclear division of labor. In response to this, the MDBs have begun to articulate strategic alliances with such organizations to design and implement projects. For MDBs (and IDA in particular), such steps are imperative if they are to continue to be the preferred channel for concessional resources.

Third, there is the *division of labor between the MDBs themselves*. There have been frequent calls for a clearer definition of responsibilities between the World Bank and the regional development banks and, to a lesser extent, between the regional and the sub-regional development banks. Mutual suspicion and different institutional personalities have prevented more effective co-ordination in the MDB system. Asymmetric power relations between members of the MDB family have often heightened suspicions and conspired to achieve smooth working relationships. Although discussions concerning the Comprehensive Development Framework (CDF) and specific cooperation agreements (e.g. the recent Memorandum of Understanding between the African Development Band and the World Bank), it is necessary to intensify coordination efforts in order to reduce operational overlaps and improve efficiency (harmonization of procedures, pooling of staff, joint missions, exchange of information, sharing of knowledge management systems, common strategies in selected sectors).

(xxxi) The various *MDBs are in quite different situations with respect to their capital and replenishment needs to support their regular lending operations*. What is clear over the medium to longer term, however, is that if the MDB system as a whole (or for that matter its individual members) wishes to maintain positive net transfers with its borrowers in the long run, further capital increases and increases in the size of replenishments will be necessary.

At approximately current levels of lending (which came down sharply after the Asian crisis) the World Bank does not appear to need a capital increase for several years. The Inter-American Development Bank is in a comfortable position and may not need a capital increase for a long time, and the European Bank for Reconstruction and Development - which started operations a decade ago, is in the same situation. The African Development Bank increased its capital recently. Its projections and the quite limited number of countries currently eligible for Bank lending indicate that a further capital increase will not likely be required for at least the next 3-4 years. The Asian Development Bank was seriously affected by the East Asian financial crisis of 1997-1998, and appears to be the regional development bank most in need of a capital increase (its capital is less than half of that of the Inter-American Development Bank, even though it has a larger constituency to serve). The situation is less clear with sub-regional development banks, although it appears that the European Investment Bank, the Islamic Bank, the Arab Fund and the Andean Finance Corporation are well capitalized for several years to come at their current operation levels. The Caribbean Development Bank and the Central American Bank for Economic Integration appear to be experiencing difficulties that may require capital increases.

All *MDBs face restrictions regarding their soft loan windows, to the extent of generating doubts about the future prospects for concessional lending*. It appears probable that the best that can be expected is that the total volume of Official Development Assistance, both through multilateral and bilateral channels, will remain at current levels in nominal terms, which implies a decline in real terms. Given low rates of economic growth and of domestic savings in many poor countries, this gives rise to legitimate doubts about the prospects for the poverty reduction objectives agreed for 2015 and for the central role that MDBs are being asked to play in that connection. The current HIPC initiative bears directly on this.

If the HIPC debt cancellation initiative is not fully and timely funded, it could conceivably reduce the total amount of concessional resources available for the poorest countries, primarily because reflows to MDB soft loan windows would be significantly lowered. Donors facing high HIPC costs for their bilateral programs may have a difficult time contributing both to the HIPC Trust Fund and to subsequent replenishments of the concessional funds. Lower reflows and stagnant replenishments imply reductions in the level of future soft window loans. This is crucial for those HIPCs whose sustainable level of borrowing after debt relief can be achieved only at grant or IDA rates. There is genuine and legitimate concern in the MDBs that unless the HIPC initiative is adequately funded on a timely basis and unless donors contribute additional resources for future soft-loan window replenishments, the net effect of the initiative for many of the poorest countries may be negative over the medium and long term.

(xxxii) *Changes are required in the way MDBs, and in particular the World Bank, relate to borrowers*. MDBs have accumulated a broad base of knowledge about development policies and strategies, and could thus become 'knowledge institutions', ready to learn and adapt on the basis of experience. The considerable unevenness between MDBs, however, has made it difficult to achieve this across the MDB family. Even though other MDBs have tried to build their own research and policy advice capacities, the World Bank continues to be dominant as the main purveyor of development ideas. In addition and although its policy prescriptions change significantly over time, a 'the Bank can never be wrong' mentality still prevails in much of the institution's thoughts and actions. This impairs the World Bank's ability to learn and creates an accountability deficit. By contrast, some sub-regional MDBs appear overly deferential to borrowing country governments, which could undermine sound policy advice and conditions established by regional development banks and the World Bank for access to financial resources.

The Comprehensive Development Framework (CDF) and the Poverty Reduction Strategy Papers (PRSP) could be used to engage borrowers in a more meaningful dialogue with the MDBs and with other development assistance agencies. However imperfect their application may be, especially when viewed from the ground up, they are preferable to country assistance strategies unilaterally designed by MDB staff. Nevertheless, for these instruments to play a positive role MDBs must be prepared to accept strategies and policies different from those they espouse and collaborate with other institutions and organizations, particularly to integrate institutional considerations into the design of CDFs and PRSPs. Greater interaction with borrowing country members requires staff time, intensive consultations and possibly a more substantive field presence. It also raises the costs of MDB operations. Again, there is great unevenness across the MDBs with regard to such capabilities and this, in turn, adds further support to the importance of systemic approaches.

(xxxiii) If the MDBs are to meet the multiple challenges outlined above and to play the increasingly complex roles expected of them, *it will be necessary to increase operating and net income*. This is the only way to cover administrative costs, increase reserves, make transfers to their soft-loan windows and provide grants to finance public goods. Decisions on the management of operating and net income should be based on strategic views of the roles MDBs will play in the future. The costs of increasing operating and net income should be equitably distributed among shareholders, seeking to balance increases in callable and paid-in capital, increases in loan charges, charges for non-lending services, and pressures on staff to reduce administration costs.

Much greater flexibility in budget procedures and multi-annual budgets are also essential to improve the administration of MDBs, allowing them to make a more efficient use of resources. This would require a major shift from the public agency style of budget management of MDBs, which involves a fair degree of Board micro-management, to a style of budget management more in tune with modern resource allocation and use practices (decentralization, cost centers, performance indicators, outcomes and results accountability).

Concluding remarks

(xxxiv) *Shareholders and senior MDB staff should react with a sense of urgency to the challenges implied by the major transformations that are now under way in the international context*. In particular, there is an important role for concerned small non-borrowing shareholders in support of the MDBs. Many of these participate in several MDBs, which gives them a broad perspective on the operations of these institutions as a whole. They should help articulate a shared perspective of the future of MDBs, acknowledging their limitations and shortcomings, but forcefully mobilizing support for their continued existence and gradual expansion.

(xxvi) In addition to paying attention to the World Bank and the regional development banks, *it is necessary to pay greater attention to the smaller sub-regional banks*. They often play an important role when viewed from the perspective of the borrowing countries, and should intensify and improve their interactions with other members of the MDB family. Also, the absence of sub-regional institutions in a region as large and diverse as Asia is quite striking and merits further examination.

(xxvii) Under attack from both conservative and radical positions, the MDBs need champions among their smaller non-borrowing shareholders. Their motivations are less suspect than those of big developed country shareholders and of borrowing member countries, they understand well the strengths and weaknesses of MDBs, and they are well poised to exert leadership in a renewal of a somewhat disparate family of rather unique and most useful institutions.

1. INTRODUCTION

This study is part of a new initiative launched by the Government of Sweden under the title *Development Financing 2000*. It comes at a time when many informed observers are expressing deep concern over the general state of global and regional institutions and, more generally, on the future of multilateralism. It follows earlier initiatives of the Swedish government, which focused both on the effectiveness of the United Nations and its role in the development process, and on the functioning and prospects of the Multilateral Development Banks (MDBs).

The role of international financial institutions has been subject to unprecedented scrutiny over the last decade. The demise of the Soviet Union ended the Cold War competition between West and East for the support of developing countries. Fiscal tightening in advanced industrial countries led to increasing scrutiny of the effectiveness of aid policies. The 50th anniversary of the Bretton Woods institutions acted as a magnet to public questioning of the continued existence of the World Bank and International Monetary Fund. This came from both left and right; from the community of non-governmental organizations that launched the '50 years is enough' campaign and from radical proponents of *laissez-faire*.

These factors are of deep concern to Sweden whose international policy has consistently espoused both effective multilateralism and development cooperation. The principal aims of the new *Development Financing 2000* are to examine the current functioning of the MDBs and to seek, as appropriate, the means and policies to strengthen them as major components of the multilateral system. While the remit of the current study is the current situation and future prospects of the MDBs, the policy issues involved can be adequately understood only in relation to the larger context.

This study offers a scrutiny of the MDBs in that larger context. It attempts to provide a frame of reference to examine the main issues that affect the future evolution of the MDBs. It is based on a review of the extensive and growing literature on the subject[1], on research conducted by the members of the IDS team, and on interviews with senior MDB staff members, government officials and policy makers, financial sector experts and researchers. In addition, the participation of IDS team members in several conferences and seminars afforded the gathering of additional information and views on the future of the MDBs.

This report begins by describing the evolving strategic context for the operations of MDBs (section 2) and then focuses on the main features of the changing structure of development finance (section 3). Section 4 examines some salient aspects of the Multilateral Development Bank family of institutions. Section 5 articulates a framework for strategic choices and explores their policy implications for the MDBs. Concluding remarks are provided in Section 6. Several annexes provide details on some of the key issues covered by this report.

---

[1] Specially the following reports: Percy Mistry and Paul Thyness, *Financing the multilateral system: Options for funding the UN system and the development banks*; Percy Mistry, *Multilateral Development Bank: An assessment of their financial structures, policies and practices*; Serving a changing world, Report of the Task Force on MDBs, Development Committee, The World Bank/IMF; Roy Culpeper, *MDBs: Titans and Behemoth?*; CSIS, *The United States and the MDBs: A Report of the CSIS Task Force on the Multilateral Development Banks*; Michael Klein, *One hundred years after Bretton Woods: A future history of the World Bank Group*; Stephen Eccles and Catherine Gwin, *Supporting effective aid: A framework of Multilateral Development Banks*; and Barbara Upton, *The Multilateral Development Banks: Improved U.S. Leadership*.

2. THE MULTILATERAL DEVELOPMENT BANKS IN AN EVOLVING CONTEXT

2.1 *The origins and evolution of development cooperation*

The development cooperation experiment of the last fifty years, aimed at improving the living standards in poor countries, was launched at a very special period of history. The end of World War II and a process of economic internationalization provided a backdrop for the evolution of development thinking and practice, and also for the creation of development cooperation institutions and instruments.[2]

The successful implementation of the Marshall Plan inspired a belief in the effectiveness of foreign assistance programs, and the economic successes of the postwar decades reinforced this belief. The period of unprecedented world economic growth from the late 1940s to the mid-1970s - referred to as a Golden Age by economic historians - fuelled an era of international generosity and a major expansion of international cooperation. The Cold War, with two superpowers competing for the allegiance of poorer nations, added a geopolitical and strategic impetus to development assistance.

Notwithstanding the creation of the World Bank in 1944, development assistance between the late 1940s and the early 1960s was mostly bilateral. However, from the mid-1960s to the mid-1970s the creation of regional MDBs and of UN agencies and programs, as well as of a number of more focused regional and subregional cooperation initiatives, signaled the beginning of a major expansion of multilateral aid. Financial assistance through multilateral channels grew faster than bilateral aid, and the share of multilateral assistance increased from about 25 percent in 1970 to about 35 percent in 1980.

The debt crisis of the early and mid-1980s modified and expanded yet further the role of multilateral finance and of the MDBs. Structural adjustment programs, facilities and loans were launched by the World Bank and the International Monetary Fund, and regional banks created their own policy-based, fast-disbursing lending instruments. This helped many developing countries to weather their liquidity and insolvency crises of the 1980s and helped to avoid a collapse of many international commercial banks. In the process, however, there was a significant expansion in the MDBs share of total developing country debt and, by the early 1990s, roughly 50 percent of total official development finance was in multilateral development finance. A further surge took place in 1997-1998 primarily as a result of the Asian financial crisis. This latter surge has since subsided and multilateral financing is returning to pre-crisis levels.

Turning to programs and projects, for over three decades (1945-1980) development assistance focused primarily on investment projects in infrastructure, agriculture, industry and the social sectors. The MDBs in particular became specialists in the planning, supervising, monitoring and execution of projects-based investments. By the early 1980s, however, an increasing number of studies and evaluations were showing that many of the projects supported with external technical and financial resources were failing to yield the anticipated rates of return. This was generally attributed to weaknesses and distortions in national policy environments. By the mid-1980s, 'policy reform' had become the main defining feature of

---

[2] See Annex B for a description of the evolution of development cooperation and Annex C for an account of the changes in development thinking and practice.

multilateral finance. MDBs pressed borrowing countries for changes in policies, and most developing countries accepted the need for reforms, including a better balance between market forces and state intervention. But policy reforms served to highlight other factors, namely that most reforms depend both on the capacity of governments to formulate and manage policy taking into account sector differences, and on private sector capabilities to assess and apply the policy environment to enterprise performance. ‘Capacity building’ became a watchword companion to policy reform. The shareholders of the MDBs made it clear that the early emphasis on investment financing need to be supplemented with a variety of interventions to build social capital and institutions.

Thus, in addition to growing in numbers, during the last fifty years, the mandates and functions of development assistance organizations, including the MDBs, have shifted and evolved in major ways in order to accommodate changing circumstances. New governmental and intergovernmental institutions, programs, funding mechanisms and procedures have emerged. Similar expansion and change has been seen in private assistance by foundations, charitable institutions, NGOs, and religious groups throughout the world.

As a result, there has emerged a vast, dense and at times almost impenetrable forest of development assistance organizations. As these agencies demanded counterparts, a corresponding assortment of government and non-governmental organizations have been established in the developing countries. By the end of the 20th century, many developing countries were expressing alarm that the growing and increasingly complex set of organizational arrangements, a result of incremental institutional innovations, had become heavy and unwieldy. At the same time, internationalism confronts a heightened aid fatigue and a slow decline in the level of resources available for international development assistance.

The limitations and shortcomings of the decades-old institutional arrangements for development cooperation - including the MDBs - also became evident during the 1990s. In many industrialized nations this coincided with a new ideological orientation that reduced the role of governments in economic development. Seeking to reduce government spending, conservative politicians in several developed countries found an easy target in foreign aid programs, which were depicted as being wasteful and ineffective. This has increased the pressure on international development institutions, precisely at a time when they are being asked to play a larger role in reducing world poverty, in helping to cope with financial crisis, and in providing global and regional public goods.

2.2 *The international development system and the international financial system*

The evolution of development thinking and practice over the past fifty years, therefore, has led to the emergence of a large number of institutions, organizations and agencies at all levels - from the local to the global. These are all part of the *international development system,* which also brings together the state, the private sector and civil society. All of these, in turn, interact with each other in a myriad ways that determine the success or failure of development efforts.

The opening and integration of capital markets, especially over the last decade, have produced an explosive growth in the *international financial system.* Previously unimaginable amounts of money now move via a multiplicity of actors throughout the main financial centers of the world. To a large extent, finance has cut itself loose from trade and production, and financial transactions have acquired an independent life of their own. This has increased opportunities internationally for obtaining access to large private sources of capital, but at the same time it has created new sources of instability that are of deep concern to policy makers and that have produced calls for new approaches to international regulation.

The broad field of *development finance* falls at the intersect between the international development system and the international financial system. A number of institutions are located in this intersection, including international and regional organizations (such as United Nations agencies), bilateral assistance agencies, private foundations, the International Monetary Fund and the MDBs. There is, however, a particular quality with regard to the MDBs. Unlike most others, they interact with all other entities that straddle the worlds of development and of international finance (Figure 1) and this places them uniquely at this intersection.

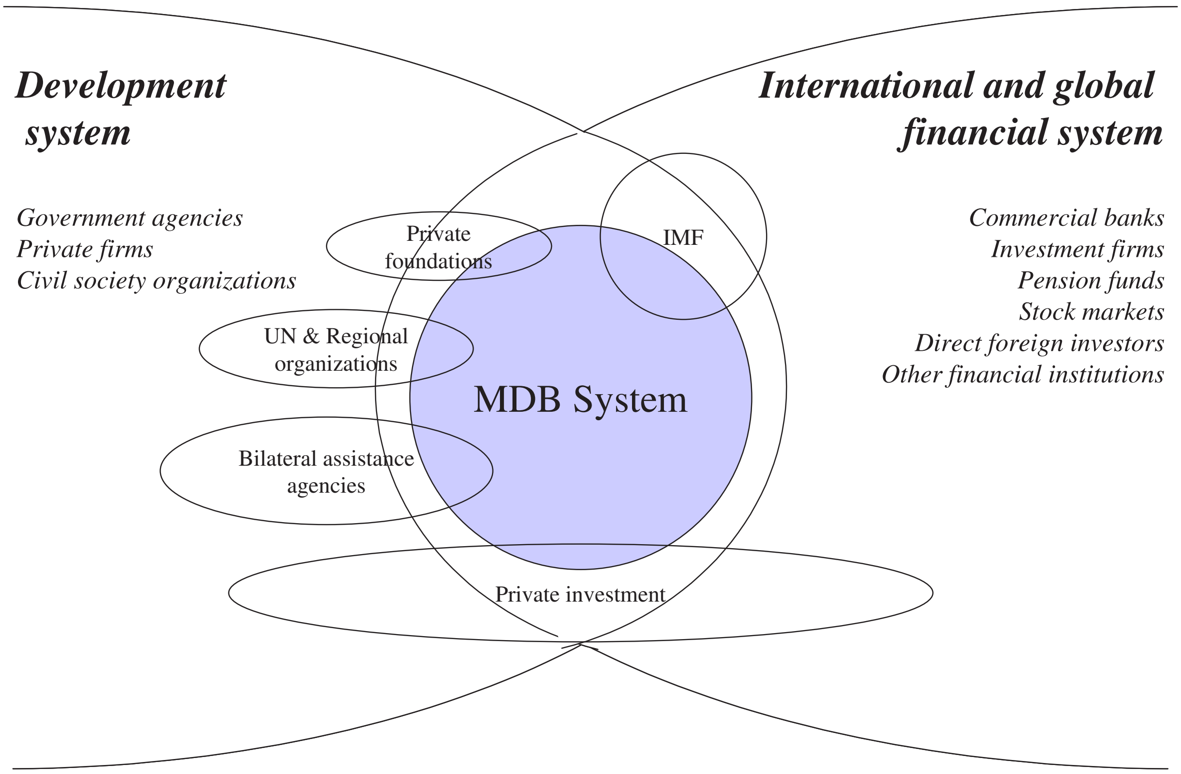
2.3 *The nature of multilateral development banks*

The MDB model is a most useful institutional innovation to assist developing countries. In spite of many problems and shortcomings, independent analyses have consistently confirmed a reasonably positive track record and the fact that there are no other institutions that provide a comparable range of products and services to member countries. Neither private sources nor bilateral agencies could have leveraged financial resources so efficiently in terms of cost, amount and leverage, while at the same time making available a range of complementary services to their borrowers. With the possible exception of similar organizations that would benefit from automatic resource mobilization mechanisms (e.g. international taxes), there are no alternative institutional innovations in sight that could provide the combination of financial resource mobilization, capacity building and institutional development, knowledge brokering and the provision of international public goods.

The MDBs, therefore, can be defined in the following terms:

> *Multilateral Development Banks are international financial intermediaries whose shareholders include both borrowing developing countries and donor developed countries. They mobilize resources from private capital markets and from official sources to make loans to developing countries on better than market terms, they provide technical assistance and advice for economic and social development, and they also provide a range of complementary services to developing countries and to the international development community.*

FIGURE 1
The development system, the international financial system and the Multilateral Development Banks



MDBs have product lines that include long-term loans at below market rates of interest, concessional loans at very low rates of interest and long repayment periods, guarantees to enhance private investment, and relatively small amounts of grant financing, mostly for technical assistance, training and capacity building in borrowing countries. Most MDBs fund their long-term loan operations through borrowings in the international capital markets, whereas concessional loans and small grants are funded through contributions by donors (also called replenishments) and from the MDBs net income.

Other features of MDBs include their preferred creditor status in relation to private lenders, and their low gearing ratios in comparison with private financial institutions. As a result, MDBs enjoy high ratings from bond rating agencies, which allow them to raise fund on favorable terms in the international capital markets. They mostly provide loans directly to governments or to public institutions with government guarantees, even though private sector operations - done directly or through their private sector affiliates - have become increasingly important for some of them. Box 1 summarizes what some analysts have called the 'traditional' model of a multilateral development bank or international financial institution.

More than twenty institutions that are jointly owned by sovereign countries and that lend to developing countries qualify according to this broad definition of a Multilateral Development Bank (Table 1). MDBs can be differentiated according to size, number and characteristics of their shareholders, type of borrowers (public vs. private, income levels), geographical scope (global, regional, sub-regional), and by the sectors or activities they cover.

Most studies of MDBs have focused on the World Bank, the oldest and largest of the MDBs, and on the regional development banks (Inter-American Development Bank, Asian Development Bank, African Development Bank, and European Bank for Reconstruction and Development) which come next in size and membership and which were established during the 1950s and 1960s (with the exception of the EBRD, which was established in 1991). However, there are also many smaller MDBs ('sub regionals'). These are regarded as very important by many developing country borrowers. While it would be desirable to include all MDBs in this study, time and financial limitations have not permitted this, although the study does attempt to include information about some of them.

There is an inherent tension between the *financing* and *development* missions of the MDBs, a tension that has been there since these institutions were created. MDBs must simultaneously raise capital in world financial markets and obtain concessional resources from donor countries to make loans to its borrowing countries, while at the same time providing technical assistance, grants, and concessional financing to their poorest members. This delicate balancing act between acting as a bank and financial intermediary, on the one hand, and meeting the development needs of the world's poorest countries and peoples, on the other, has now become much more difficult. As a recent World Bank internal report pointed out, 'At times during the Bank's history, its finances have taken on increased importance in internal debates and discussions - typically when its financial capacity has looked as though it could constrain the Bank's ability to deliver on its development mandate. The Bank is now in the midst of one of those periods'. Other MDBs are facing similar problems. Moreover, a new mission has been added to the MDBs during the 1990s. In addition to their *financing* and *development* roles, these institutions are being asked to play a *service* role in the provision of regional and global public goods. In addition to the provision of information and the conduct of research and studies on development issues, this new function extends to fields such as environmental protection, coping with health epidemics, preventing deadly conflict and maintaining the stability of the international financial system.

2.4 *A changing context for MDB operations*

Three features of the international scene affect significantly the prospects for and future evolution of the MDBs: the emergence of a 'fractured global order', the increasing heterogeneity of developing countries and the questioning of development assistance in general, and of the MDBs in particular.

2.4.1 *A fractured global order*

As we enter into the 21st century there is an accelerated, segmented and uneven process of globalization presently under way. The worldwide expansion of productive and service activities, the growth of international trade, the diminishing importance of national frontiers, and the pervasive effects of new information technologies, all coexist with the concentration of 'global' activities in certain countries, regions and even neighborhoods, as well as within certain firms and corporations.[3]

[3] See Annex D for a more detailed description of the fractured global order.

BOX 1

The traditional model of a Multilateral Development Bank: A preferred creditor with sovereign borrowers

What distinguishes Multilateral Development Banks from other financing institutions? The most obvious difference is that their shareholders are governments and that their Articles of Association are international treaties between sovereign states. This feature of MDBs makes them a very special intermediary for capital flows from savers in wealthier countries to investors in poorer ones.

If we start with the model of the World Bank (the oldest MDB, founded in 1944), the intention is that borrowers should be either governments or parastatal agencies that operate under government tutelage. Indeed, the requirement that borrowers obtain a government guarantee is included in the World Bank's Statutes. Thus, the traditional model of MDB is one of raising funds on international capital markets and lending to governments.

The AAA credit rating for the World Bank, and its ability to borrow on the very best terms, comes from its financial strength. The total outstanding loan book can be no more than its subscribed capital plus reserves, so even in the extreme case of every borrower defaulting with no recovery of principal, the entire loss would be absorbed by shareholders - and creditors would be unaffected. Only a very small proportion (a few percent) of an MDB subscribed capital is actually paid-in as cash. The rest is callable by the institutions in the event it is needed. This callable capital is guarantee of IFI operations by the shareholders. The approach is essentially the same for most other IFIs.

A special feature of MDBs is their multilateral nature, meaning that default would have repercussions on all other shareholders. This is a much more powerful deterrent than possible bilateral problems between a particular borrower and lender. The result is that borrowers default against an MDB in only the most extreme circumstances, as shown by their rather low percentage of non-accrual loans (with the exception of the African Development Bank). The comparison between institutions is complicated by the fact that some also lend to private sector and so they are exposed to commercial risks. Indeed, the IFC lends only to the private sector.

The key point is that the international framework has created a preferred creditor that cannot be credibly duplicated by private sector lenders. The Paris Club of official creditors can be seen as a way of trying to put debt problems into a multilateral context once they have occurred. However, setting lending in a formal multilateral framework before loan contracts are signed is obviously a much more transparent and robust solution.

All this means that the cost of a state providing callable capital to an MDB is very low, since the likelihood that it will ever be called (the guarantee exercised) is small. It also means that there is a good reason why MDBs can price their sovereign loans on a non-discriminatory, cost-plus basis. While the market must consider individual sovereign risks, these do not exist in the same way for the MDBs.

This also explains why debt relief, if funded by the IFIs themselves, must be approached with extreme caution. Such debt forgiveness schemes amount to default in all but name. To agree to debt write off could undermine the preferred creditor framework unless there are the most carefully defined and controlled conditions. This may seem an easy way out for MDBs, and it is particularly galling for some observers who accuse MDBs of contributing to current difficulties through irresponsible lending practices in the past. However, someone must pay the cost of sovereign defaults. If this were to become a common phenomenon, MDBs would have no choice but to charge a risk premium or stop this type of lending. In either case, the traditional model collapses.

Adapted from: Christopher Hurst and Eric Perée, 'Only a mid-life crisis? The future for IFIs in an integrated world', *European Investment Bank Papers*, Volume 3, No. 2, 1998, pp. 10-29. (His emphasis).

TABLE 1
The family of Multilateral Development Banks

*The World Bank Group**

International Bank for Reconstruction and Development (IBRD)
International Development Association (IDA)
International Finance Corporation (IFC)

Regional Development Banks

Inter-American Development Bank (IADB)
Fund for Special Operations (FSO)
Inter-American Investment Corporation (IIC)

African Development Bank (AfDB)
African Development Fund (AfDF)

Asian Development Bank (AsDB)
Asian Development Fund (AsDF)

European Bank for Reconstruction and Development (EBRD)

Sub-regional Development Banks

European Investment Bank (EIB)

Central American Bank for Economic Integration (CABEI)

Caribbean Development Bank (CDB)

Corporación Andina de Fomento (CAF)

Nordic Investment Bank (NIB)

Islamic Development Bank (IDB)

East African Development Bank (EADB)

Arab Bank for Economic Development In Africa (BADEA)

West African Development Bank (BOAD)

North American Development Bank (NADB) (newly created).

Other Funds

Nordic Development Fund (NDF)

International Fund for Agricultural and Rural Development (IFAD)

Arab Fund for Economic and Social Development (AFESD)

OPEC Fund

*The World Bank Group includes also the Multilateral Investment Guarantee Agency (MIGA) and the International Center for the Settlement of Investment Disputes (ICSID) which do not provide loans.

The simultaneous integration and exclusion of countries - and of peoples within countries - are two intertwined aspects of today's multidimensional processes of globalization and fragmentation. This is a new order - a fractured global order - that is global but not integrated. It joins up the world, but simultaneously maintains deep fissures between different groups of countries and between peoples within countries. It benefits disproportionately a small percentage of humanity and segregates a large portion of the world's population.

This fractured order is perhaps the most important challenge faced by the international community in the 21st century. Development, as it has been understood in the second half of the twentieth century, simply will not be possible unless ways are found to prevent these fractures from creating inward-looking societies - both between and within rich and poor nations - that relate to one another only through symbolic links forged by mass media or through narrowly circumscribed economic transactions. Efforts to meet this challenge imply a commitment to build bridges across the multiple fractures of the emerging global order. The MDBs should continue to play a major role in this process.

2.4.2 *Growing heterogeneity of developing countries*

Developing countries have become more heterogeneous, wealth, income and knowledge disparities are widening, and the interests of recipients of development assistance and diverging. This divergence is particularly true with regard to loans, technical assistance and services from the MDBs. Not only have the developing countries become more diverse, but also a new set of transition economies have been added to the list of countries eligible to borrow from the MDBs. Table A – 1 in the Annex presents the classification used by the Development Assistance Committee (DAC) of the OECD, which is based primarily on income per capita considerations, to which the Human Development Index for each country and the averages of this index for each category of countries have been added.

The needs and requirements of each group of country are quite diverse, as are those of different countries in each of the categories. The needs of the least developed countries center on concessional finance, technical assistance, and support for capacity building. Upper middle and high income countries may require program finance, emergency lending and policy dialogue. It is interesting to notice that as one moves from a lower to a higher average income per capita the dispersion in the Human Development Index becomes smaller, suggesting some sort of convergence. This may suggest that the needs of countries with lower income levels may be more varied than those of countries with higher income levels, which would indicate the need for greater efforts in the preparation of lending and other MDB operations in the poorer countries.

As the MDBs have moved over time from relatively simple and self-contained investment projects towards program loans, adjustment operations, institutional development and policy dialogue, among other forms of interactions with their stakeholders, the quantity and diversity of demands on staff have grown considerably. This has implications of the skill mix of MDB professionals and for the time it takes to prepare loans and other operations. The adoption of poverty reduction as an overarching objective for the MDBs, together with the inclusion of governance, conflict prevention and related issues, has raised even higher the stakes for MDB staff at a time of increasing constraints on administrative budget. This risks less than adequate attention to the special requirements and characteristics of diverse groups of borrowers, and in particular to the poorest countries which need the most attention.

2.4.3 *Questioning development assistance and the role of the MDBs*

During the last decade, as never before, the purposes, means and impact of development assistance have been called into question. The combination of diminishing resources of development assistance and growing demands from both developing countries and transitional economies, has catalyzed such questioning and led to numerous studies and reports on the subject.[4]

The perceived ineffectiveness of international development cooperation has been considered as an important contributing factor to explain donor fatigue, which is reflected in the diminishing public support for government spending on foreign aid and in the reduction in Official Development Assistance flows. Considering the wide diversity of motivations for development assistance (see Table 6), the multiplicity of delivery channels and the different objectives of various programs, it is not surprising that when aid is viewed from a particular perspective —reducing poverty, empowering women, containing ethnic conflicts, helping refugees, protecting the environment, building local capacity in the recipient country, or promoting donor country exports, among others— specific projects and programs can be seen to fall short of expectations.

Criticisms of development assistance and of the MDBs can be grouped into three categories: (i) radical critiques that consider aid harmful; (ii) criticisms that consider development assistance as beneficial but rather inefficient, and; (iii) those that view it as appropriate only for the poorest countries, arguing that it crowds out private investment in all other developing countries and transition economies.

The *radical critiques of development assistance* in all its forms, whether bilateral, multilateral or private, are voiced mostly by some academics and representatives of non-governmental organizations. These critics argue that development assistance is harmful, has nothing to show for billions of dollars provided to poor countries, and that the whole aid enterprise is a waste of taxpayer money. An extreme example of such critiques is provided by Graham Hancock, who argues that ‘aid is not bad, however, because it is sometimes misused, corrupt or crass; rather, it is *inherently* bad, bad to the bone, and utterly beyond reform’ and that it is ‘the most formidable obstacle to the productive endeavors of the poor’.[5]

The *critics that focus on how to improve the effectiveness of development assistance* see it as beneficial but riddled with delivery and efficiency problems. For these critics ‘aid works’ but could be made to work better. Some of them focus on the shortcomings of international development institutions, and of the MDBs in particular, while others stress the

---

[4] See Annex E for a review of some questionings and criticisms of development assistance and of the role of MDBs.

[5] Graham Hancock, *Lords of poverty*. New York, The Atlantic Monthly Press, 1989; pp. 183, 192-193. Not even the most acerbic critics of development assistance have reached the vituperative level of Hancock’s characterization, on the donor side, of ‘the notorious club of parasites and hangers-on made up of the United Nations, the World Bank and the bilateral agencies’, who have reached ‘record breaking standards [of] self-serving behavior, arrogance, paternalism, moral cowardice and mendacity’ and, on the recipient side, of the ‘incompetent and venal’ leaders and of ‘governments characterized by historic ignorance, avarice and irresponsibility’ that engage in the ‘most consistent and grievous abuses of human rights that have occurred anywhere in the world since the dark ages’.

problems and difficulties at the recipient country level. Recent studies have placed emphasis on the importance of good domestic policies and institutions, arguing that they are a condition for aid to have a positive impact. However, after the Asian crisis, there have emerged serious questions and discussions about the 'good policies' advocated by the MDBs.

In particular, the World Bank and regional development banks have been attacked because of their adherence to what are perceived as a rather rigid policy prescriptions - the so-called 'Washington Consensus' - imposed on borrowers as a condition for access to resources. According to Hans Singer, 'nowhere in the Articles of Agreement of the IMF [nor of the World Bank or the regional MDBs, for that matter] is there any mandate to evolve or prescribe proper development policies to its member countries, let alone to develop the specific school of prescriptions now known as the Washington Consensus'.[6]

A World Bank study on aid, which underscores the importance of good policies and sound institutions as a condition for aid effectiveness, argues that 'what is good policy is not something that is subjectively decided in Washington. Rather, lessons about good policy emerge from the experiences of developing countries. What we mean by good management is - objectively - what has led to growth and poverty reduction in the developing world.' [7] However, considering the frequent changes in the policy advice provided by the World Bank over the last decades, and the changing nature of the evidence to support what are considered good policies, the claim to 'objectivity' has to be taken with a grain of salt.

A third group of criticisms focuses on the role of multilateral development banks, and argues that *MDBs should restrict their activities to those areas where the private sector shows no interest*. They see the regular lending operations of these institutions as 'crowding out' and reducing opportunities for private investment. Accordingly, they propose to limit the functions of the MDBs to the provision of grants, concessional assistance and project finance in countries and sectors that are unattractive to the private sector. Although these views have been popular for some time in conservative political circles, they acquired much greater prominence with the March 2000 publication of the report prepared by the International Financial Institution Advisory Committee of the US Congress, Chaired by professor Allan Meltzer.

The Meltzer report argues that the IMF and the World Bank should be radically scaled down because the 'advent of deep global capital markets, willing to bear risk and prepared to channel substantial resources to emerging economies, has destroyed the rationale for much of the costly financial intermediation function that has been the (multilateral) Banks' main activity'. Among its many other recommendations, the report proposes that all resource transfers to countries that enjoy capital-market access or with a per capita income in excess of US$ 4,000 should be phased out, and that starting at US$2,500 per capita levels, lending should be limited. Furthermore, the Commission argues that MDBs should be transformed into granting and technical assistance agencies, relying wholly on grant funds from rich-country governments. The regional development banks would become the sole providers of multilateral aid to Asia and Latin America, while the World Bank would provide assistance to some countries in Eastern Europe and Central Asia and, (along with the African Development Bank) to Africa.

---

6 Hans Singer, 'Rethinking Bretton Woods from a historical perspective', in M. Greisgraber and J. Gunter, *Promoting Development*, London, Pluto Press, 1995, p. 7.

7 David Dollar and Lance Pritchet, *Rethinking aid: What Works, What Doesn't and Why*, World Bank 1998, Washington, DC, USA; chapter 3.

The US Treasury Department responded to the Meltzer report endorsing its less controversial recommendations - for example, increasing assistance to the poorest countries, and limiting the role of MDBs in countries that enjoy widespread access to international capital markets. But, the response argued that most of the recommendations to limit and alter the activities of MDBs were based on a misinterpretation of their roles and of the way they operate.[8]

Interestingly enough, some of the recommendations made in the Meltzer report bear a striking resemblance to points made in an article by Michael Klein offering a futuristic assessment of the role of the World Bank in 2044, one hundred years after the Bretton Woods institutions were founded.[9] Klein envisaged a situation in fifty years time in which the growth of private sources made the financial role of the World Bank superfluous. Klein went much further, however, and projected a world where the lender of last resort functions were exercised by privately funded standby liquidity schemes, where voluntary and mandatory global standards and better global governance had reduced the need for conditionality, and where a global safety net had largely replaced the need for concessional assistance. Finally, Klein's futuristic assessment saw much of the Bank's information and advisory functions provided by and the Bank itself transformed into an endowed foundation funding innovative schemes to improve governance and fight poverty. Some of Klein's speculations about the place of the World Bank in the mid-21st century may have inspired some of the recommendations made by the Meltzer Commission for the immediate future.

---

8 Table E-1 in Attachment E summarizes the proposals of the Meltzer report on the role of MDBs, as well as the response of the US Treasury Department.

9 Michael Klein, 'One hundred years after Bretton Woods: A future history of the World Bank Group', *European Investment Bank Papers*, Vol. 3, No. 2, 1998, pp. 30-59.

3. THE CHANGING STRUCTURE OF DEVELOPMENT FINANCE

3.1 *External finance requirements of developing countries*

Changing conceptions of development have important implications for the operations of MDBs. In the early days of the development cooperation experiment, the main barrier to development was considered to be the lack of domestic investment, which in turn was related to inadequate savings. External financing for investment projects was seen as the way to 'prime the pump' and start a process of self-sustained economic growth. The MDBs main function was viewed in financial terms, as sources of attractive external financing. As development thinking evolved, the emphasis shifted away from an exclusive focus on closing the gap between domestic savings and investment and to greater attention on technical assistance, policy advice and the provision of regional and global public goods. These shifts notwithstanding, any assessment of the role that international financing plays in development needs to explore whether the amount and structure of private and official capital flows are adequate in view of the growth needs of developing countries.

3.1.1 *Financing gaps in developing regions*

As part of this study and predicated on the internationally agreed target of reducing world poverty by half by 2015, a quantitative exercise was conducted to estimate a possible order of magnitude of the external financing needs of developing countries.[10] The study suggests a requirement for external financing significantly in excess of the levels available at the end of the 1990s. The exercise involved the use of the savings gap model and consisted of two basic steps. First, based on the incremental capital-output ratio (ICOR), it calculated the investment rate required for achieving a certain growth rate target. Second, it calculated a financing gap between the investment required and national savings. This would be the gap to be filled by external financing.

Table 2 presents the annual average external financing needs of developing regions over the 2000-2009 period under a 'base scenario' and a 'poverty-reduction target scenario'. Growth rates under the base scenario are drawn from the current forecast of the World Bank report Global Development Finance 2000. The report offers growth rates for each developing region over the 2000-2002 period.[11] The poverty-reduction target scenario used the growth rates believed to be necessary - though not sufficient - to halve extreme poverty (i.e. those living on less than U$ 1 dollar a day) by 2015 in all developing regions.

Total annual average net external financing requirements for the developing countries, defined in terms of the amount of external resources to finance their current account deficits, amount to about US$ 220 billion during 2002-2009 under the base scenario (Table 2). This is

[10] The study was carried out by Ricardo Gottschalk as part of the IDS Foresight Study of MDBs and is reproduced in Annex F.

[11] Such growth rates are similar to those experienced by the regions between 1993 and 1997, which was the period relied upon to obtain some of the key parameters of the model, such as ICOR and savings rates. East Asia and Pacific was the exception to that, as the region's 1993-1997average growth was 8.5 percent[11], while the growth forecast in the report falls into the range of 6.1 percent -6.6 percent. In order to keep a degree of consistency between the parameters used in the simulations, in the case of East Asia and Pacific the growth rates observed in the past were used, rather than those forecast in Global Development Finance 2000.For the remaining years – 2003-2009 – growth rates being forecast for 2002 were used.

roughly of the same order of magnitude as the annual average of total net external financing registered during the 1990s, which was about US$ 230 billion**.** Under the poverty reduction scenario —even after adjustments for improvements in investment efficiency— average annual requirements for 2002-2015 are almost double, at about US $450 billion. [12]

External financing needs vary considerably across regions. In the base scenario they range from US$ 4.4 billion a year in South Asia to US$ 66.8 billion a year in Europe & Central Asia. Considerable variation can be also observed when financing needs are measured as a proportion of GDP in each region, ranging from 0.6 percent for South Asia to 6.5 percent for Sub-Saharan Africa. Under the poverty reduction target scenario, the external financing needs of Sub-Saharan Africa and Latin America and the Caribbean are significantly higher than in the base scenario. The estimated external financing needs for Latin America increase to US$ 281.1 billion (6.2 percent of the region's total GDP), and for Sub-Saharan Africa they rise to US$ 86.4 billion (12.7 percent of the region's total GDP). For comparison, in 1999 total next external financing for Latin America reached US$ 43 billion and for Sub-Saharan Africa US$ 8.8 billion.

TABLE 2

Net External Financing Needs of Developing Countries, by Region

(Annual averages)

	Base scenario[1] 2000-2009		*Poverty-reduction target scenario[2]* 2000-2015	
	US$ billion [3]	% GDP	US$ billion [3]	% GDP
East Asia & Pacific	53.2	1.9	n.d.	n.d.
South Asia	4.4	0.6	4.9	0.5
Middle East & North Africa	42.4	5.8	57.8	7.2
Sub-Saharan Africa	27.7	6.5	86.4	12.7
Europe & Central Asia[4]	66.8	5.3	24.9	2.4
Latin America & The Caribbean	26.6	0.9	281.1	6.2
TOTAL	221.1		455.1	

Notes:

1. Growth rates used in the base scenario are drawn from the current projections of the Global Development Finance 2000.
2. Growth rates used in the poverty-reduction target scenario are drawn from a report prepared the Overseas Development Institute for the UK Department for International Development.
3. The values are set in 1998 constant prices.
4. For Europe & Central Asia, financing needs under the *poverty-reduction target scenario* are smaller than under the base scenario, because in spite of its slightly higher growth rates, in the poverty-reduction target scenario a gain in capital efficiency is assumed to take place from the 6th year on.

Source: Annex F.

[12] To calculate the external financing needs under the 'poverty-reduction target scenario', some of the parameters of the 'base scenario' were modified to keep consistency with the much higher growth rates required for the objective of halving poverty reduction. If such changes were not made, the new projections of financing needs would be extremely high. For example, the net external financing needs for Latin America & The Caribbean would be of an annual average of U$ 1.6 trillion, and for Sub-Saharan Africa, of U$ 248 billion. These values are set in 1998 prices.

3.1.2 *Complementary financing for recurrent expenditures*

For many developing countries, basic services are minimal due to low levels of recurrent government expenditure. For example, the World Bank estimates that worldwide expenditures on public health are just a quarter of the level required to meet minimum requirements, mainly because of the provision gap in poor countries.[13] The governments in poor countries face chronic problems of finance for recurrent expenditure, primarily because an extremely weak capacity to raise public revenues. For several of the least developed countries, this implies negative public savings, which combine with low private sector savings levels to produce extremely low overall savings rates. In such circumstances, scarce external resources are often diverted from investment projects to recurrent expenditures. To illustrate, following the slow down of the 1980s, the 1990s witnessed a resumption of capital flows. The investment levels of low-income countries, however, did not pick up, indicating that at least part of such flows was used to finance recurrent expenditures. A slight decline in savings would also appear to reinforce this hypothesis. The generally low investment and savings rates in Sub-Saharan Africa during the 1990s - around 17 percent and some years as low as 14 percent - suggest that this might indeed have been the case, with external resources being directed to fill in budgetary gaps rather than to support investment projects.

In order to finance additional recurrent expenditures, the measures usually recommended are to raise private savings (which can then be taxed or borrowed) or to increase consumption-based tax revenues. These may be feasible measures for middle-income countries in Latin America, but for the majority of Sub-Saharan countries, which are extremely poor, there is no room for reducing private consumption. Moreover, other policy measures such as trade liberalization usually reduce customs duties and tariffs and, at least over the short-term, the possibility of raising revenues. For poverty reduction in such countries, therefore, recurrent expenditures would need to be financed with supplementary external resources. In practice this means that bilateral donors and MDBs would need to provide financing for budget support in the poorest countries.

Mozambique provides an illustration of the problems involved in financing recurrent expenditures. Life expectancy, infant mortality, adult literacy and other social indicators are amongst the worst in Sub-Saharan Africa. Between 1991 and 1995 - the immediate post-war reconstruction period - total government revenues averaged about 20 percent of GDP, but expenditures in health and education reached up to 50 percent of GDP and 20 percent of total recurrent expenditures. Most of the fiscal gap was financed with external grants. Even with such grants, however, the World Bank calculates that a doubling of recurrent expenditure is needed for basic health and primary education. Mozambique is one of the few countries that has already met the pre-conditions for debt relief under the Highly Indebted Poor Countries (HIPC) initiative, but all projections indicate that the relief being envisaged under the current criteria will be insufficient to meet the country's daunting needs.

The conclusion is clear: if internationally agreed poverty reduction targets are to be taken seriously, the external financing requirements will exceed by a large margin the amounts of development financing - both public and private - that have been registered during the last decade.

---

[13] World Bank, *World Development Report 1997: The State in a Changing World*, Washington DC, 1997.

3.2 *The evolution of financial flows to developing countries*

There have been several fundamental shifts in the size, composition and distribution of external capital inflows to developing countries. This has been particularly the case for private financial flows which comprise funds raised on foreign financial markets, trade-related financing and foreign investment (Figures 2 and 3). The aggregate figures show that from about 1950-1972, the most important sources of external financing for developing countries were official loans and aid. Foreign direct investment (FDI) during that period fluctuated between 20-30 percent of external financing and, at the same time, there was an expansion in export credit. Thus, for roughly twenty years a quite stable pattern existed in financial flows to developing countries. This came to a sudden end with the first 'oil shock' in the early 1970s. From 1975 until the early 1980s, private capital accounted for almost two-thirds of total inflows, primarily in the form of loans from international private banks, which recycled the surpluses of major oil exporters.

This era of rapid expansion in private capital flows was also to come to a sharp end. Starting in about 1982, the deflationary macro-economic policies pursued by the industrialized world triggered a deep global recession, accompanied by collapsing commodity prices and a Third World debt crisis. The result was to reverse the positive net flows of resources to the developing world that had characterized the preceding 25 years. During the rest of the 1980s capital inflows to developing countries remained virtually stagnant: while official development assistance increased moderately, private financing fell sharply. For many developing countries, especially in Latin America and sub-Saharan Africa, the 1980s became the 'lost decade' in terms of economic growth and social development. In 1985 developing countries transferred about US$15 billion more to rich-country donors, banks and corporations than they received in the form of aid, loans and investment[14].

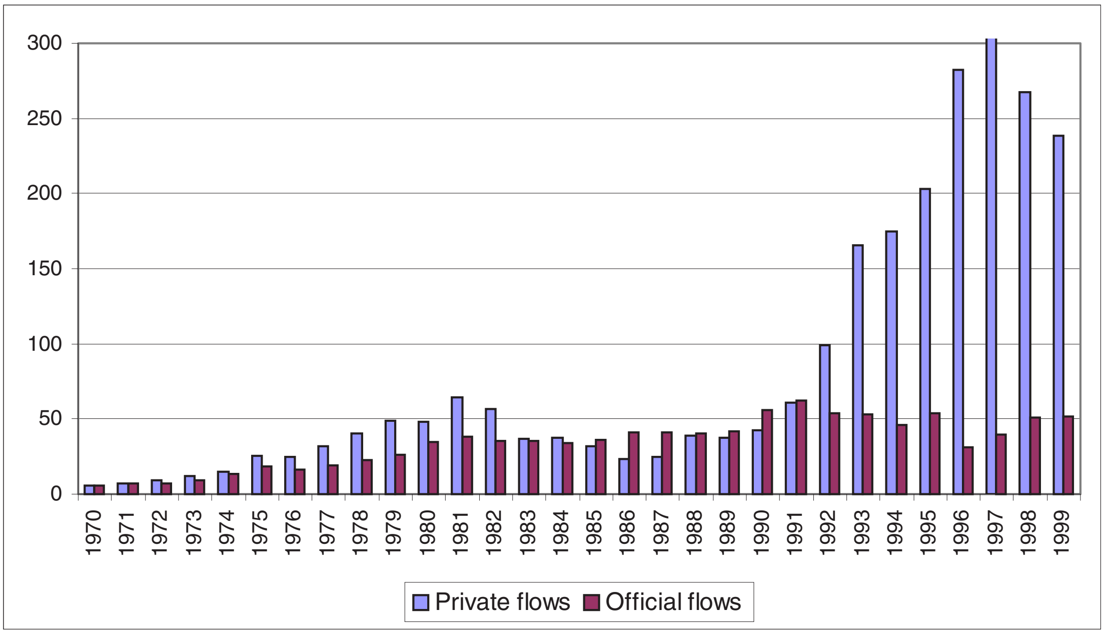
3.3 *Private sources of development finance*

With the 1990s came yet another reversal in the form of an unprecedented expansion in private capital inflows to developing countries. These increased sevenfold from 1990 to 1997 and now dominate the international finance scene. In 1990, less than half the international capital flows to the developing world came from private sources, by 1997 the private share had risen to about 90 percent. Much of this was of the private-to-private type, rather than private-to-public flows as in previous decades. This seismic financial shift was the result of two factors: first the greater mobility of international capital associated with financial globalization, and secondly the attitude of developing country governments. During the 1990s developing countries welcomed foreign capital with open arms - a clear reversal of the prevailing attitudes of earlier decades. Policies which discouraged foreign investment were repealed (e.g. ownership restrictions), and new policies were adopted to encourage foreign investors (e.g. property rights protection, tax stability guarantees). Privatization of public enterprises, which became quite common in developing world during the 1990s, also played a significant role.

---

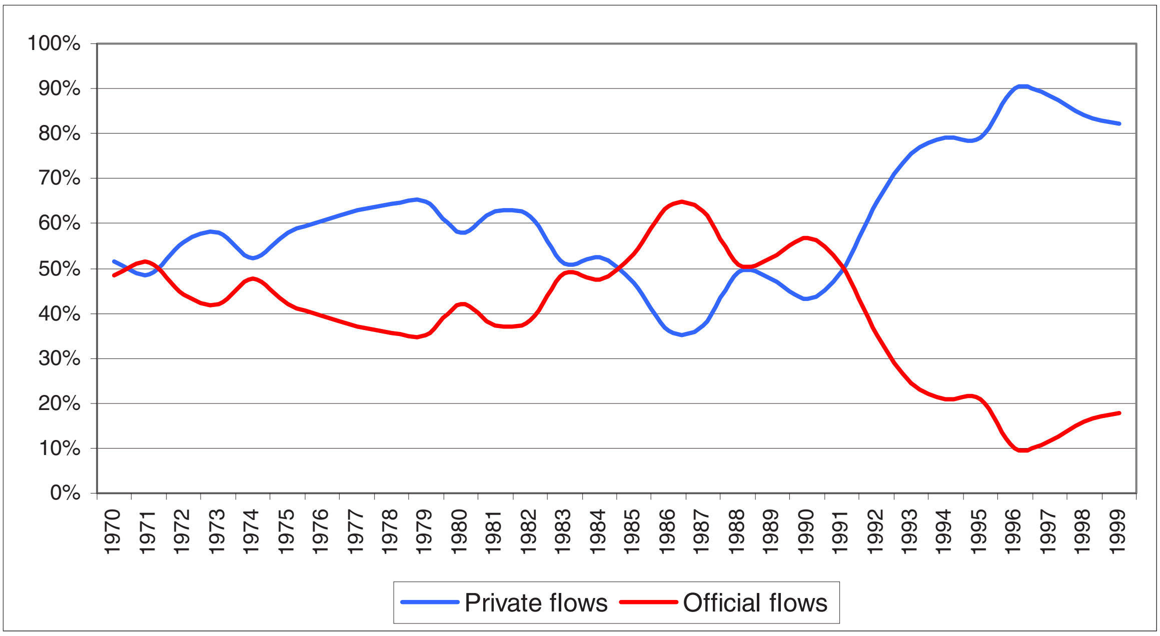
14 Michael Edwards, *Future Positive: International Co-operation in the 21st century*, London, EarthScan Publications, 1999, p. 90.

FIGURE 2
Official Flows and Private Flows to developing countries
(US$ billion)



Source: World Bank, Global Development Finance 2000 (CD-ROM)

FIGURE 3
Official Flows and Private Flows as percentage of total net Resource flows to developing countries
(Percent of total)



Source: World Bank, Global Development Finance 2000 (CD-ROM)

These private flows, however, are highly concentrated in a relatively few middle income and a couple of low income economies (China and India),[15] and also in a few sectors such as energy, minerals and telecommunications. Moreover, the current trend is to further concentration. On average over the past twenty years, about 40 percent of total private net capital inflows went to only 20 developing countries. By 1999, this had doubled to roughly 80 percent, leaving the remaining 20 percent to be shared among the more than 110 countries. Indeed, the top ten recipients of private net capital inflows now account for 70 percent of the total (Figure 4). In addition, the regional distribution of private capital flows changed significantly from the 1980s to the 1990s. A roughly balanced distribution between developing regions in the 1980s gave way to a concentration in East Asia and Latin America, which captured 42 and 32 percent of total net private capital inflows, respectively, in 1990 (Figure 5).

The impressive increase in private flows to Asian and Latin American economies has not been matched, at least in relative terms, in sub-Saharan Africa. At the beginning of the 1970s, both East Asia and Sub-Saharan Africa were in similar positions with private flows accounting for about 40 percent share of total net transfers. In dollar terms, this amounted to about US$1 billion annually. By 1997, however, total net transfers to East Asia had increased spectacularly to about US$110 billion annually, and the share of private flows had risen to over 80 percent of total net resource transfers. In contrast, private net transfers in Sub-Saharan Africa rose only to about US$ 9.5 billion in 1997, and the share of private flows remained at the same level (Annex Figure A-2).

The decade of the 1990s also brought two major disruptions to the level and distribution of capital flows to developing countries. The Mexican peso crisis of 1994 occasioned the first disruption involving a broad sell-off of developing countries' securities, which was especially evident in Latin American markets. For example, developing country issues of bonds fell from US$15 billion in the last quarter of 1994 to US$ 5 billion in the first quarter of 1995, while Latin American bond issues fell even more sharply during the same period, from $5 billion to US$0.5 billion. At the same time, developing country equity issues fell from $6 billion to $0.6 billion between the last quarter of 1994 and the first quarter of 1995. In Latin America international equity issuance fell abruptly and the region - which had raised US$1 billion in equities during the last quarter of 1994 - was unable to raise any in the first quarter of 1995[16].

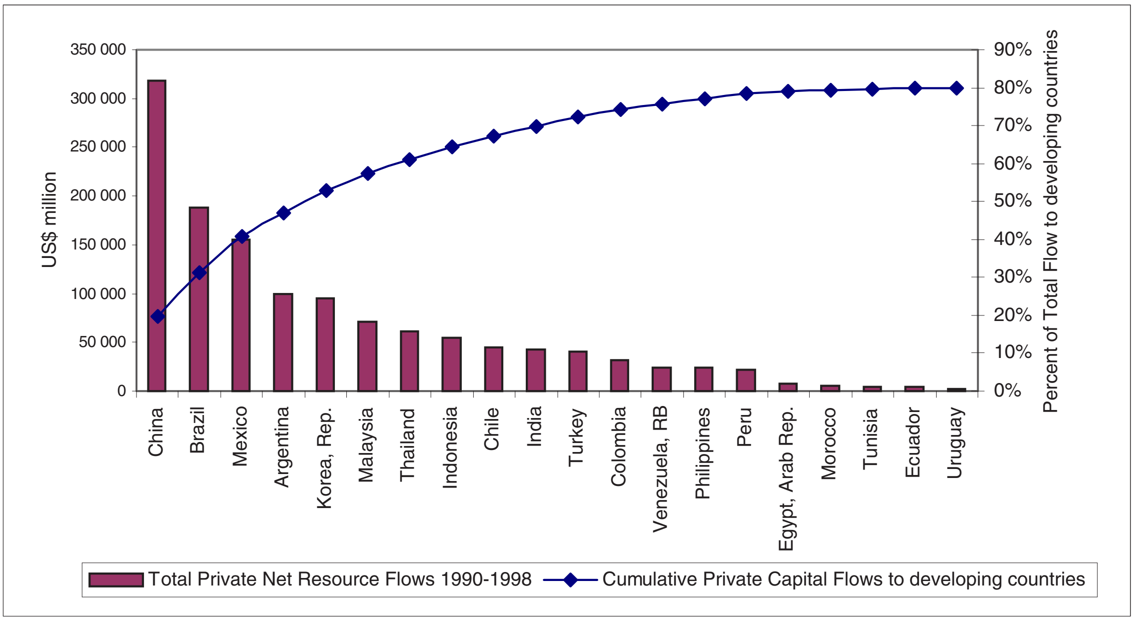
A second serious disruption of capital flows took place in the second half of 1997 with the South East Asian crisis and its extended contagion effects. Private capital inflows to emerging market economies reached US$140 billion in 1996 and plummeted to US$40 billion in 1997 as the first waves of financial turmoil hit the developing world. In 1998 private inflows dried up completely. International bank lending which fell from US$86 billion in 1996 to US$20 billion in 1997 was a contributing factor. According to the estimates of the Institute of International Finance, the five affected Asian developing countries (Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand) suffered net private outflows of US$6 billion in 1997 compared to net inflows of US$94 billion in 1996. This sharp US$100 billion reversal represented about 10 percent of their combined GDP, perhaps the largest such reversal in recent economic history. While the level of FDI did not

[15] Usually referred to as the 'emerging markets'.

[16] Stephany Griffith-Jones, 'International Capital Flows and their Management', Paper No. 13 UNDP. Taken from web site www.undp.org.

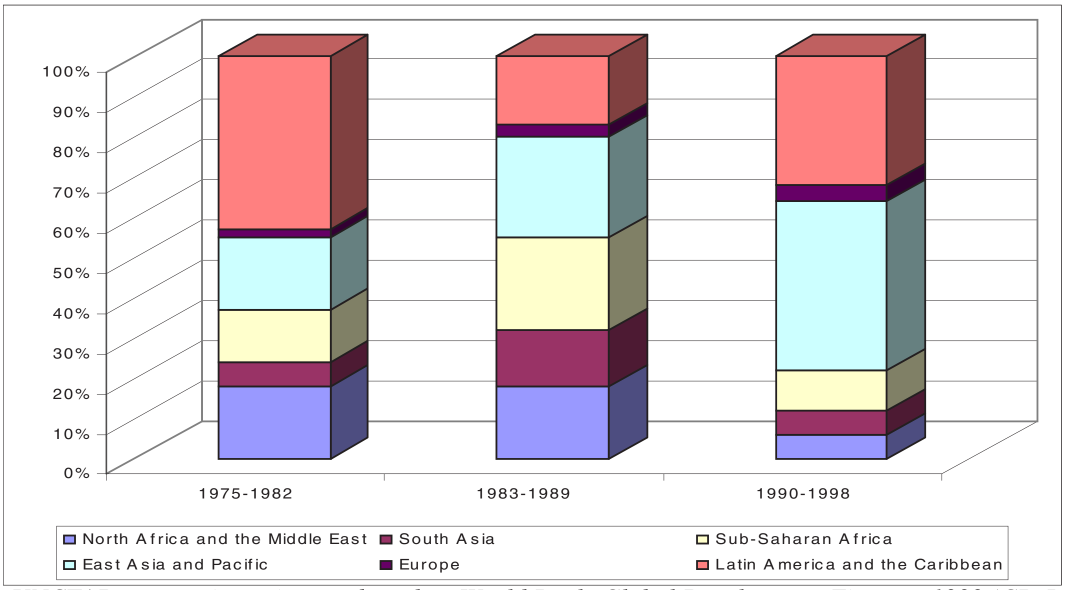
change very much and stood around US $7 billion, the sharpest decline occurred in the case of lending from commercial banks, followed by portfolio equity investment.[17]

FIGURE 4
Concentration of Private Capital Flows, 1990-1998
(US$ Billion)



Source: World Bank, Global Development Finance 2000 (CD-ROM)
Note: The list of emerging markets is found in Yilmaz Akyuz and Andrew Cornford, 'Capital flows to developing countries and the reform of the international financial system', UNCTAD Discussion Paper No. 143, November 1999, p. 12.

FIGURE 5
Developing countries: net capital inflow, by region, 1975-1998
(Percentage of aggregate net capital inflow)



Sources: UNCTAD secretariat estimates, based on World Bank, Global Development Finance, 1999 (CD-ROM)

[17] Bank of International Settlements, *Annual Report 1999*, Basle, 1999, p. 33; and Development Assistance Committee, *Development Co-operation 1998*, Paris, OECD, 1999.

There is an important 'supply side' distinction between the surge in capital flows that occurred in the 1990s and the one witnessed in the 1970s. In the 1970s, bank lending was the major channel through which developing countries obtained private capital from abroad. The share of bank lending in private capital flows was more than 60 percent for all developing countries, whereas foreign direct investment and portfolio investment (bonds and equity) were relatively unimportant. By the end of the 1990s the share of foreign direct investments in total private flows was about 85 percent, whereas the share of bank lending had diminished sharply (Table 3).

TABLE 3
Distribution of net long term private capital flows to developing countries
1990 – 1999
(US$ Billion)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999a
Total	98.5	124.0	153.7	219.2	220.4	257.2	313.1	343.7	318.3	290.7
Official flows	55.9	62.3	54.0	53.3	45.9	53.9	31.0	39.9	50.6	52.0
Private flows	42.6	61.6	99.7	165.8	174.5	203.3	282.1	303.9	267.7	238.7
International capital markets	18.5	26.4	52.2	99.8	85.7	98.3	151.3	133.6	96.8	46.7
Debt flows	15.7	18.8	38.1	48.8	50.5	62.2	102.1	103.4	81.2	19.1
Bank lending	3.2	5.0	16.4	3.5	8.8	30.4	37.5	51.6	44.6	-11.1
Bond financing	1.2	10.9	11.1	36.6	38.2	30.8	62.4	48.9	39.7	25.0
Other	11.3	2.8	10.7	8.7	3.5	1.0	2.2	3.0	-3.1	5.5
Equity flows	2.8	7.6	14.1	51.0	35.2	36.1	49.2	30.2	15.6	27.6
Foreign Direct Investment	24.1	35.3	47.5	66.0	88.8	105.0	130.8	170.3	170.9	192.0

Note: long-term resource flows are defined as net liability transactions or original maturity of greater than one year.
a. Preliminary
Source: World Bank, *Global Development Finance 2000*, p. 26

The above overview demonstrates clearly that a central feature of private flows to developing countries has been volatility, expressed in sudden surges and reversals over relatively short periods of time. This has been related to the changing composition of these flows and to the behavior of different types of investors. Foreign portfolio investment (FPI) has been by far the most volatile (eight times more volatile than FDI per unit of stock) followed by bank credits (two times more volatile than FDI). These relative differences in volatility, however, require careful interpretation. For example, East Asia's large stock of accumulated short-term (less than one year maturity) bank debt before the crisis was the principal factor in the capital flow reversal and capital markets disruptions of 1997 and 1998.[18]

[18] Stephany Griffith-Jones and Jacques Cailloux, "Global capital flows to East Asia, surges and reversals" IDS, University of Sussex 1999, p. 30.

3.3.1 *Foreign Direct Investment (FDI)*

Foreign direct investment (FDI) by transnational corporations setting up facilities in developing countries has expanded eightfold during the last decade, from US$24 billion in 1990 to more than US$192 billion in 1999 (Table 3). Developing countries' share of global FDI flows has risen from 12 percent in 1990 to around 36 percent in 1997, before declining to an estimated 25 percent in 1998[19] (the decline in that year was due to large increases in mergers and acquisition activity in industrial countries). FDI is considered by most observers to be especially important to development because it involves long-term commitments, brings technology, know-how and management skills, and it does not add to a country's debt burden (even though profit remittances could offset some of these benefits).

Motivations for longer term investments in developing countries have evolved over time (Table 4). In the 1970s and early 1980s, resource extraction and import substitution were the primary motives for FDI to developing countries. Oil has exerted a particularly strong investment pull since the dawn of the petroleum age, with oil-producing countries accounting for fully half of all FDI flows to developing countries between 1979 and 1981. At present, a high proportion of FDI flows to developing countries can be characterized as efficiency-seeking investments, associated with the globalization of production.

TABLE 4
Main Economic Determinants for Different Types of Direct Foreign Investment

Type of FDI classified by motives of Transnational Corporations	Principal economic determinants in the host countries
Market seeking	▪ Market size and per capita income ▪ Market growth ▪ Access to regional and global markets ▪ Country-specific consumer preferences ▪ Structure of markets
Resource/asset seeking	▪ Raw materials ▪ Low-cost unskilled labor ▪ Skilled labor ▪ Technological, innovatory and other created assets (e.g. brand names) including in individuals, forms and clusters. ▪ Physical infrastructure (ports, roads, power, telecommunication)
Efficiency seeking	▪ Costs of resources and assets listed under B, adjusted for productivity for labor resources ▪ Other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products Membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: UNCTAD, *World Investment Report 1998: Trends and Determinants*, Geneva, p. 91

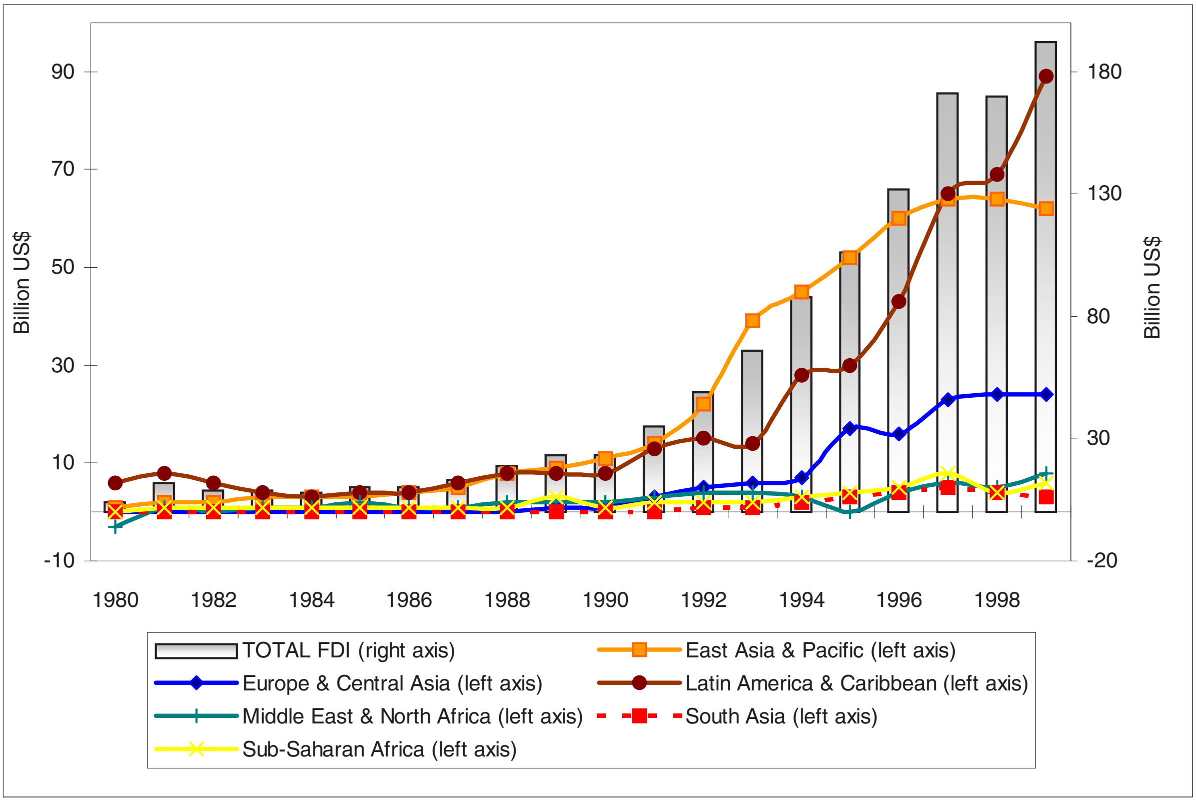
FDI flows have been significantly more stable than portfolio flows and have remained resilient over the past several years, in spite of the Asian financial crisis and the more generalized contagion that accompanied it. Large shifts of stocks of FDI cannot be made in the same way that portfolio flows can be moved from country to country, especially if these are intertwined in international production networks or where 'sunk' costs are high. FDI flows are, however, subject to slowdowns or reversals in response to economic difficulty.

[19] World Bank, *Global Development Finance*, Washington DC, 2000, p. 42.

The increased uncertainties that accompany economic crises do cause investors to reduce new commitments, accelerate affiliates' repayments of debt to home offices, or take offsetting positions through derivatives.

There is considerably regional variation in FDI flows. East Asia accounted for about 50 percent of FDI flows to developing countries in the 1990s (mostly efficiency-seeking FDI), with Latin America a distant second at 28 percent (Figure 6). In the early 1990s, a sizeable proportion of the flows to Latin America were a consequence of one-off privatizations, but countries in Latin America have also been receiving efficiency-driven FDI.

FIGURE 6
Total FDI net inflows to developing countries by regions, 1980-1999
(US$ Billion)



Source: World Banks, Global Development Finance 2000 (CD-ROM)

3.3.2 *Foreign Portfolio Investment (FPI)*

The dramatic shifts that have occurred in net private flows to developing countries in recent years has been primarily the result of activity in international capital markets (bond issues, syndicated bank lending, and portfolio equity). Portfolio investment is more prone to reversals than foreign direct investment, as it is mediated through financial markets and is highly sensitive to changes in the investment environment.

Developing countries and countries in transition accounted for nearly 17 percent of all equities and debt securities issued on international capital markets in 1996 and 1997. The volumes, however, have been subject to wide fluctuations (equities equivalent to US$15.0 billion in 1996, US$29.3 billion in 1997 and US$11.2 billion in 1998). A similar pattern of wide swings has been evident in international debt securities issues by developing and transition countries which amounted to US$88.1 billion in 1996, 89.2 billion in 1997 and US$37.1 billion in 1998.[20]

FPI has become an especially important source of capital for higher-income developing countries. With the exception of India and the Philippines, the 10 developing countries that attracted more FPI than FDI over the period 1993-1997 all have per capita GDP exceeding US$2,500. For eight of them, the volume of external finance raised through bonds was higher than that raised through equities.[21]

Mutual funds, which channel money from individual investors, grew in the 1990s as a percentage of total FPI. Mutual fund managers are concerned about potentially large losses producing large scale redemptions from retail clients, most of which can pull out their money immediately.[22] Thus, mutual investors tend to move in a more volatile manner than do other institutional investors, such as pension funds and insurance companies. Other sources of portfolio flows, for example, pension funds, seem to be less volatile because their liabilities (pension rights in the fairly distant future) are far more long-term than the liabilities of mutual funds. However, even pension funds are prone to some volatility, spurred by herding behavior, as different funds move together to match the average pension fund's performance.

3.3.3 *Prospects for private capital flows to developing countries*

The general consensus seems to be that the supply of funds to riskier emerging market borrowers will expand steadily, although perhaps cautiously at first, over the next few years. In the long term, private flows are expected to rise significantly, with capital flowing not only from industrial countries to developing countries, but increasingly among developing countries themselves. Two main reasons explain this consensus. First, many emerging market economies are still in the early stages of policy reforms. The policy reforms that are being embarked upon - which focus on macroeconomic stability and the promotion of more deregulated, outward-oriented, and market-based economies - are likely to provide significant opportunities for productive investments.

Second, although it is difficult to speculate on the nature of future innovation and technological change, competitive pressures and increasing integration have been stimulating investments in technology that are likely to continue to reduce transactions costs and make distant markets more accessible to small as well as large investors. Such innovations will make policy-induced barriers less effective, spurring even more deregulation and competition. Third, an important factor that will provide further impetus to these underlying trends is the demographic shift under way in industrial countries. Industrial countries now have a pronounced bulge in their demographic structure, reflecting the aging of the baby boom generation and declining birth rates. This will lead to a steady rise in the proportion of elderly to active population in all industrial countries, mainly Japan. This is in sharp contrast the majority of developing countries, whose clearly pyramidal structure reflects a much

---

[20] Data on international issues of equities and debt securities are reported by the Bank for International Settlements, in its *Quarterly Review on International Banking and Financial Market Developments*.

[21] UNCTAD, 'Trends in FDI and Ways and Means of Enhancing FDI Flows to and among developing countries', TD/B/COM.2/21, Geneva, June 1999.

[22] Indeed, it was the fear of retail investors' redemptions - rather than actual redemptions - which made mutual funds (especially US ones) pull out of Mexico as the news about economic deterioration increased, and thus contributed both to provoke and magnify the crisis that occurred.

younger population[23]. There are three broad implications of this difference in demographic patterns. First, the aging of populations in industrial countries should lead to an increase in savings as they reach closer to retirement age in the short to medium term. Second, aging and the associated slowing of labor force growth is likely to exert downward pressure on the rate of return to capital relative to that of labor in industrial countries. The reverse can be expected in developing countries, given their demographic structure. Third, the aging of populations in industrial countries is leading to pressures for pension reform. These reforms are likely to result in greater responsiveness on the part of pension funds to investment opportunities to developing countries.

For these reasons, private capital flows to developing countries should be expected to increase over the next two decades. A generally increasing trend in foreign direct and portfolio investments, however, is unlikely to reverse the extreme degree of concentration of private flows in a few emerging and transition economies, as well as in a few sectors. The motivations of private investors are linked to the highest possible private rates of return. Private capital flows will not as a general rule be directed to areas and sectors with high social rates of return (i.e. to areas of most urgent priority in the poorest developing regions).

Moreover, dramatic increases in private capital inflows to developing countries have proved to be a double-edged sword. Although they have allowed for rapid economic growth, the cases of Mexico and East Asia illustrate that they can also lead to serious financial crises with repercussions on the international financial system as a whole. Developing countries are particularly vulnerable owing to their dependence on foreign capital and their net external indebtedness. Since systemic deficiencies in the current regime for capital flows and exchange rates regularly give rise to costly financial crises in developing countries - regardless of institutional and policy differences amongst them - global financial reform is a priority issue for these countries.

Indeed, even countries that have enjoyed access to private capital markets have discovered that they may not be able to raise international funds when they most need them. Only about 30 percent of the developing and transition countries receive ratings from Standard & Poor, and only about half of those qualify for an investment grade rating (Table 5).

The considerations outlined above indicate that while private sources of capital will increase significantly over the next decade, they are likely to play a major role in financing the investment needs of only a relatively small number of developing countries. This high degree of concentration of private capital, together with the volatility of portfolio flows, makes is improbable that private international capital will act in the majority of poorer countries as the main engine for development. Moreover, private capital flows are will not, in general, be assigned to areas of greatest social impact or towards the long-term task of building local capabilities. Based on this assessment, the most reasonable conclusion is that official and other non private sources of financing will be imperative to development efforts for the foreseeable future. An equally reasonable conclusion is that the MDBs will have a particularly important role to play in helping finance development in those countries that are not able to attract private capital. MDB financing can also help mitigate the problems caused by the concentration and volatility of private flows, which are exacerbated at times of international financial stress.

---

[23] World Bank, *Private Capital Flows to Developing Countries*, Washington DC, 1997.

TABLE 5
Sovereign Rates for developing countries (above BB+ rate)
(week of August 4, 2000)

Sovereign	Foreign Currency		
	Long-term rating	Outlook	Short-term rating
Upper middle income countries and territories			
Chile	A-	Stable	A-1
Malaysia	BBB	Stable	A-3
South Africa	BBB-	Stable	A-3
Trinidad & Tobago	BBB-	Stable	A-3
Uruguay	BBB-	Stable	A-3
Croatia	BBB-	Negative	A-3
Mexico	BB+	Positive	B
Threshold for World Bank loan eligibility			
Malta	A	Stable	A-1
Slovenia	A	Stable	A-1
Barbados	A-	Stable	A-2
Oman	BBB-	Stable	A-3
High income countries and territories			
Korea	BBB	Positive	A-3
Lower middle income countries and territories			
Tunisia	BBB	Stable	A-3
Thailand	BBB-	Stable	A-3
Trinidad & Tobago	BBB-	Stable	A-3
El Salvador	BB+	Stable	B
Panama	BB+	Stable	B
Philippines	BB+	Stable	B
Costa Rica	BB+	Stable	B
Other low middle income countries and territories			
China	BBB	Stable	A-3
Central and Eastern European countries and New Independent States of the former Soviet Union			
Czech Republic	A-	Stable	A-2
Hungary	BBB+	Positive	A-2
Estonia	BBB+	Stable	A-2
Poland	BBB+	Stable	A-2
Latvia	BBB	Stable	A-3
Lithuania	BBB-	Stable	A-3
Slovak Republic	BB+	Stable	B
More advanced developing countries and territories			
Singapore	AAA	Stable	A-1+
Bermuda	AA	Stable	A-1+
Cyprus	A	Stable	A-1
Hong Kong	A	Stable	A-1
Kuwait	A	Stable	A-1
Israel	A-	Positive	A-1
Qatar	BBB	Stable	A-3

Source: DAC List of countries from OECD website http://www.oecd.org
Sovereign ratings from Standard & Poor ´s (04/8/2000)

3.4 *Official capital flows*

Private financing, whatever its increasingly importance and potential, will not over the next several years be an adequate substitute for Official Development Assistance (ODA), particularly for the poorest countries. The evidence, therefore, underscores that importance of maintaining and increasing the level of ODA, for without this it will be practically impossible to achieve progress towards realistic goals of human development, such as halving world poverty by 2015. The indications regarding ODA, however, are not encouraging. After experiencing a rapid growth during the 1970s, total resources for development assistance began to level off during the 1980s and to decline in the 1990s. In fact Official Development Assistance disbursements have actually decreased in real terms since 1988, with the recent exception of a minor increase in 1998.

3.4.1 *Aid fatigue and decline in ODA flows*

Fiscal constraints in donor countries and the questioning of the effectiveness of aid appear to be transforming 'aid fatigue' into outright 'aid exhaustion.' Between 1992 and 1997, total ODA from DAC member countries[24] to developing countries and multilateral institutions fell steadily from 0.33 percent of their combined GNP to a record low of 0.22 percent, although it increased slightly in 1998 (Figures 7 and 8). During the twenty year period from 1975-1976 to 1995-1996, the United States share of total ODA was more than halved, from over 30 percent to less than 15 percent.

The decline in ODA during the 1990s was reflected in difficulties in securing even previously agreed levels of resources for the tenth (1994-1996) and eleventh (1997-1999) replenishments of the International Development Association (IDA) of the World Bank group. For example, IDA-10 negotiations failed to raise additional resources for the 'Earth Increment,' which had been agreed at the 1992 United Nations Conference on Environment and Development (UNCED) in Rio de Janeiro, to help in the transition towards environmentally sustainable development. Even though the provisional trust fund allowed IDA to maintain an annual level of disbursements close to $6 billion between 1995-1997, the troubled IDA-11 negotiations may have signaled the end of nearly three decades during which multilateral concessional assistance increased at a steady pace.[25]

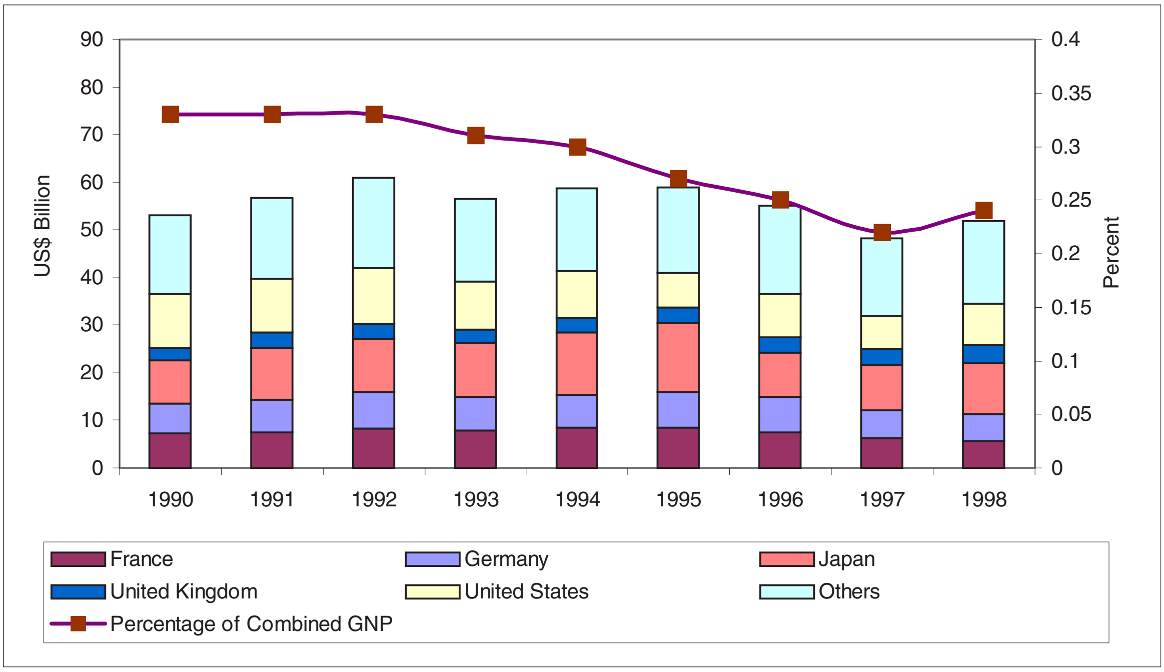
Even as the total volume of aid has declined, the number of countries providing development assistance and the number of aid agencies has increased, as has the role of international non-governmental organizations. This expansion has come in response to growing demands, a desire to accommodate more diverse needs and the emergence of new donor countries (e.g. Ireland, Portugal, Singapore, South Korea), but it has also some times resulted in a proliferation of projects, administrative overload and coordination problems in recipient countries.

---

24 Development Assistance Committee (DAC) members include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and the United States.

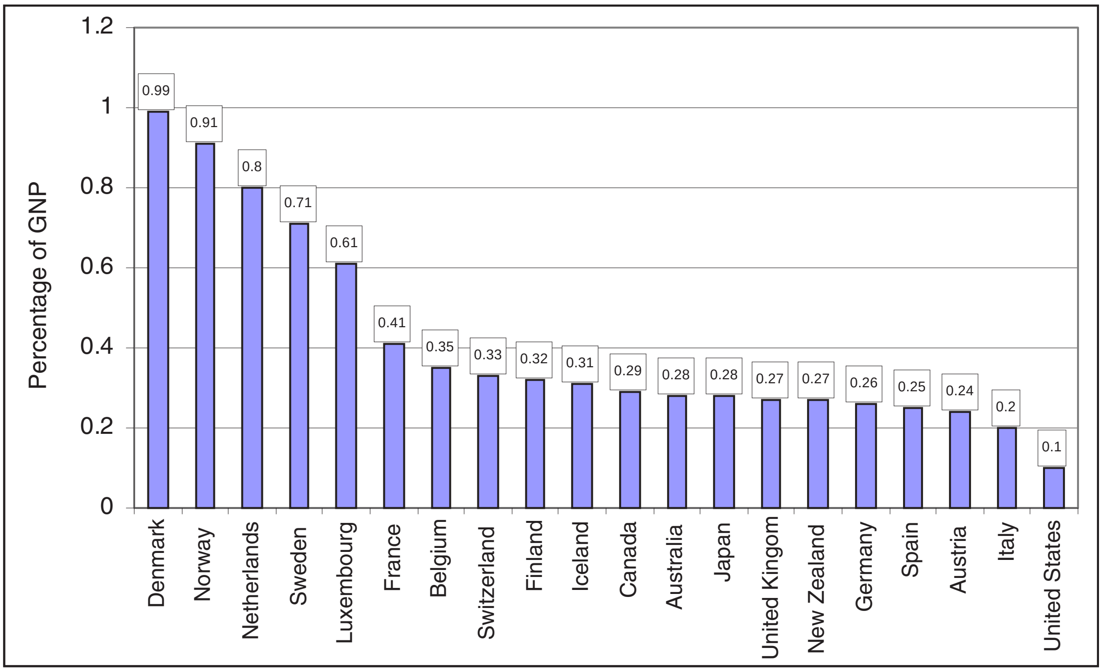
25 The difficulties experienced by IDA financing have led to suggestions of alternative approaches for raising the resources necessary to keep IDA in operation at a steady level indefinitely - for, example, the establishment of a fund to subsidize the interest rates of regular (IBRD) loans provided by the World Bank. See, for example, J. Sanford, *Alternative ways to fund the International Development Association* (IDA), World Development 1997, 25 (3), 297-310.

FIGURE 7
Net Official Development Assistance Flows from DAC countries, 1990-1998



Source: Development Assistance Committee (DAC) Dev*elopment Co-operation 1999*, Paris, OECD; and World Bank, *Global Development Finance 2000*, Washington DC, p. 59.

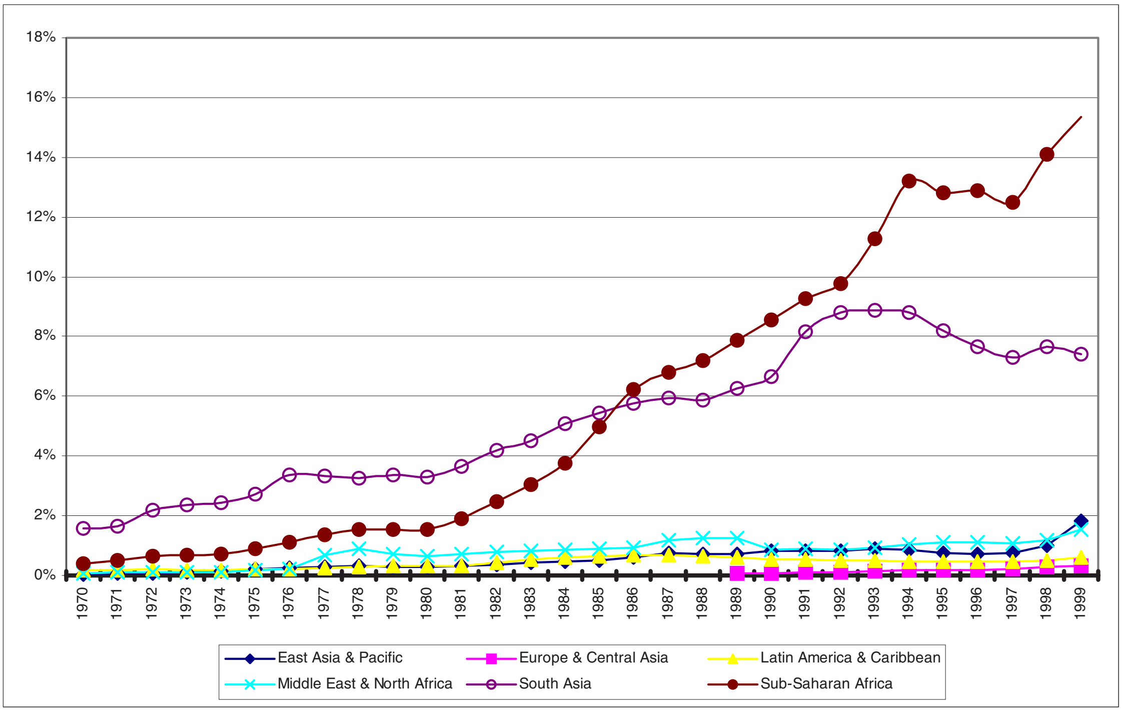
FIGURE 8
Net ODA in 1998-as percentage of GNP



Source: Development Assistance Committee (DAC) Dev*elopment Co-operation 1999*, Paris, OECD; and World Bank, *Global Development Finance 2000*, Washington DC, p. 59.

Falling levels of ODA have a serious impact on the poorest developing countries, particularly in Sub-Saharan Africa. Concessional MDB flows and bilateral aid are an important source of revenue in many countries, and reductions force significant cuts in investment and recurrent expenditures. For instance, in 7 out of 13 most-aid dependent countries, aid averaged 90 percent of total government revenue in 1992.[26] During 1995-1996, aid was equivalent to more than a fifth of GNP in Eritrea, Tanzania, and Zambia.[27] Among a sample of mainly low-income countries in different regions, Sub-Saharan Africa has the highest aid dependency (as measured by the ratio of aid to GNP), and receives three time more foreign aid per capita than other developing regions (Figure 9).

FIGURE 9
Official Net Resource Flows Dependency by Region, 1980-1999
(percentage of GNP)



Note: The series is defined as the ratio between outstanding and disbursed concessional debt from multilateral banks and regional GNP.
Source: World Bank, Global Development Finance 2000 (CD-ROM).

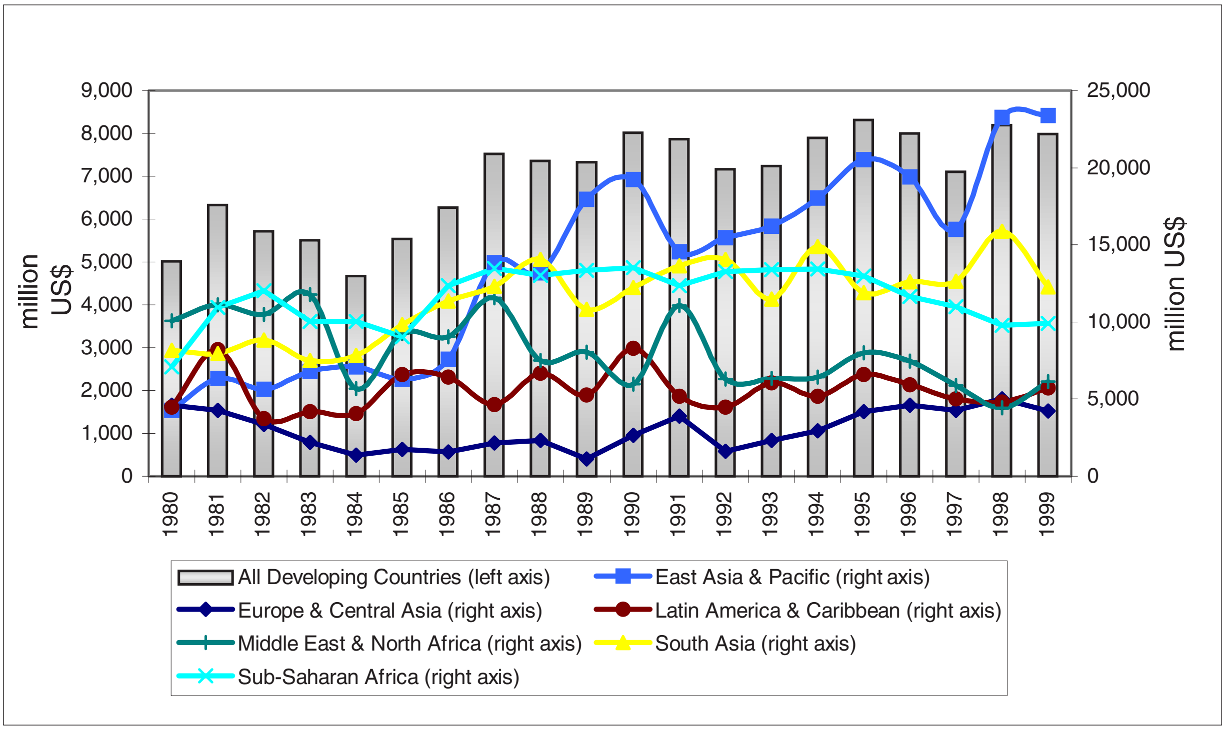
The regional allocation of total concessional flows shows that East Asia and Pacific receives by far the highest share of ODA in absolute terms, followed by Sub-Saharan Africa and South Asia (Figure 10). Europe and Central Asia receive the smallest amount of ODA, although its share has been steadily growing since 1990. In 1995, this region received $9 billion or about 15 percent of the resources provided by the countries of the Development Assistance Committee. ODA flows to South Asia and Sub-Saharan Africa have stabilized and most recently declined. Still, virtually every region has been experiencing a long-term downward trend in concessional aid flows relative to its GNP since 1990. This is especially notable in the case of Sub-Saharan Africa, and may be attributed, at least in part, to the past poor performance of aid in Africa. There is an apparent reallocation of aid in favor of

[26] According to the World Bank, all seven - Burkina Faso, Madagascar, Mongolia, Nicaragua, Rwanda, Sierra Leone, and Zambia - received aid amounting to more than 15 percent of their GNP, *Global Development Finance 2000* p. 74, *op. cit*.

[27] See also Annex F.

countries with better policy performance, for example in East Asia and Pacific, accompanied by a large cutback of others.[28]

FIGURE 10
Concessional Disbursements by region, 1980-1999
(million US$)



Source: World Bank, Global Development Finance 2000 (CD-ROM)
Note: Includes both multilateral and bilateral concessional disbursements.

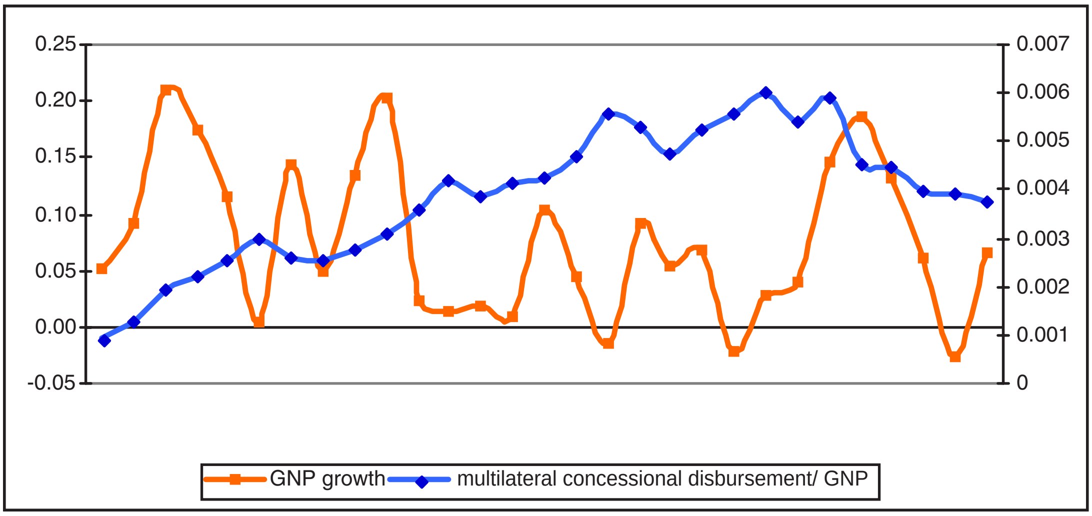
Concessional flows have helped to cushion the impact of external economic shocks in poor countries. Figure 11 shows the counter-cyclical behavior of ODA in relation to the changes of GNP growth in low-income countries. This suggests that reductions in concessional flows are likely to leave the poorest countries more exposed and vulnerable to economic downturns, let alone to natural and manmade disasters that affect their growth rates and poverty reduction efforts.

A new composition of resource flows to developing countries appears to be emerging, involving an implicit emerging trend towards allocating ODA to the tasks of social and sustainable development, while leaving more direct and immediate investments in economic growth to private financing. Several MDBs, including the World Bank and most of the regional development banks, have announced that they will assigning greater priority to lending for the social sectors (education, health, population), for environmentally sustainable development, and for reforming public administration and improving governance. The financing of economic infrastructure (particularly transport, energy and water supply) which was a traditional preserve of multilateral development banks, is now being increasingly left to the private sector, often in partnership with international financial institutions and bilateral export development agencies. In addition to social, sustainable and governance issues - to which several donors add the task of promoting their exports to developing countries - in the post-Cold War period official flows also began to finance tasks like conflict prevention,

[28] World Bank, *Global Development Finance 2000*, p. 60.

peacemaking and peacekeeping in developing regions. Assistance for such purposes is beginning to be understood as part of the development effort, in the sense that many violent conflicts are only an intensification of the struggle for power inherent in the process of economic, social, and political development.[29]

FIGURE 11
Concessional Disbursements as counter-cyclical to reduction in growth in low-income countries, 1971-1999



Source: World Bank, Global Development Finance 2000 (CD-ROM)

At lest since the 1980s, the largest share of bilateral ODA has been allocated to the provision of technical cooperation. During the last decade, an increasing share was assigned to emergency relief, both for natural and man-made disasters; this suggests a declining focus on the long term tasks of environmentally sustainable economic and social development (Figure 12). For example, between 1988 and 1993 the number of grants for refugee relief exploded from 177 to 1975 (a more than tenfold increase). Total ODA funds for emergency and distress relief grew from about US $350 million in 1980, to US $600 million in 1985, and then soared to nearly US $3.5 billion in 1994 and US $3.1 billion in 1995.

3.4.2 *Enduring and changing motivations for development assistance*

Motivations for Official Development Assistance have changed in parallel with the evolution of development thinking and of institutional arrangements for development cooperation.[30] Cold War political interests and altruism were the main reasons in the late 1940s, but over time a more varied range of motivations for development assistance began to emerge. As motivations changed, conditions for access to financial and technical assistance were redefined. Political loyalty to one of the two opposing camps in the East/West confrontation gave way to conditions regarding tied purchases of goods and services, access to markets, economic policies, institutional reforms, democratic practices, environmental conservation and respect for human rights. Cross-conditionality between development assistance agencies and multilateral institutions increased significantly, and private banks

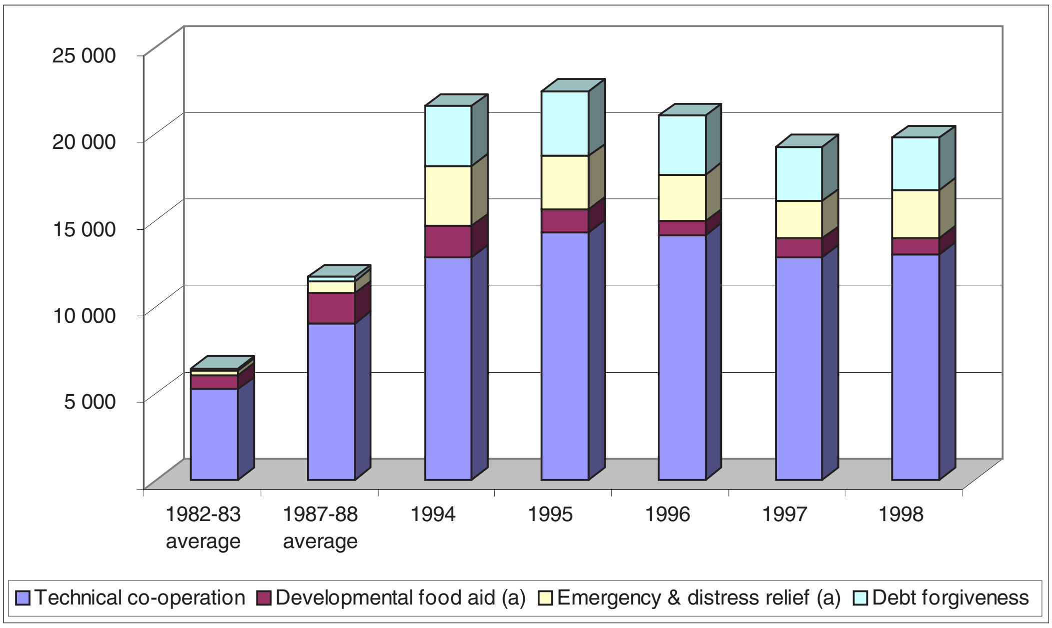
---

[29] R. Miller (ed), *Aid as peacemaker*, Ottawa, Carleton University Press 1992; J. Stremlau and F. Sagasti, *Preventing Deadly Conflict: Does the World Bank have a role?*, Carnegie Commission on Preventing Deadly Conflict, Carnegie Corporation of New York, June 1998.

[30] See Annex B and C.

often conditioned their loans to developing country governments on the adoption of policy reforms advocated by the IMF or the World Bank.

FIGURE 12
ODA Bilateral grant flows for specific purposes, 1982-1998
(US $ million)



Source: OECD, DAC Development Cooperation 1996,1998.

Table 6 suggests a summary of the main motivations for providing development assistance at present. Motivations, of course, are not mutually exclusive. Different motivations can interact closely with each other, either as complements or tradeoffs. In some cases human rights concerns may override the purely economic or political interests of donors, while in others the opposite may be true. Development financing may be made conditional on adopting political reforms, as exemplified by the loans provided by the European Bank for Reconstruction and Development (EBRD), whose articles of agreement state the promotion of multiparty democracy as one of its objectives. Environmental and security preoccupations may also reinforce each other, as in the case of assistance to the countries of Eastern Europe and the former Soviet Union to upgrade their nuclear power installations and dismantle their nuclear missiles. In general, increased interdependence and the process of globalization, added to the multiple fractures that characterize the emerging world order, have made the political, economic and social stability of the international system, as well as the provision of global and regional public goods, a growing concern of donors. Moreover, some emerging global problems have now acquired the status of 'security problems' for the most powerful countries. In January 2000, the US government decided to consider AIDS as a national security threat, which would justify allocating budget resources to help developing countries to confront this deadly disease on the grounds of preserving national security for that country.

TABLE 6
Motivations for Official Development Assistance

Strategic and security interests, which respond to geopolitical and military considerations of donor countries.
- At the national level, which justify aid to developing countries of specific geopolitical importance to the donor country.
- At regional level, which considers the interests of regional alliances or treaties.

Political interests, which focus on obtaining political support for foreign and domestic policies)
- With foreign constituencies (through support to former colonial territories and other areas with special historic and cultural ties to the donor country, aid to obtain international political recognition and support).
- Centered on domestic constituencies (obtaining the support of immigrant lobbies and ethnic groups of foreign origin in the donor country).

Economic and commercial interests. which emphasize direct commercial and financial benefits to the donor country.
- Benefits may include export expansion, employment generation, support of domestic producers (through food aid), greater security for investments in developing countries, securing access to resources (oil, strategic minerals), obtaining access to a pool of highly qualified potential migrants (through fellowships), and creating demand for exports in the future (through technology transfers).

Emergence of regional and global problems, which concern both donor and recipient nations and require the provision of public goods.
- Environmental sustainability has become a major concern of donors because global environmental threats (global warming, destruction of the ozone layer, loss of biodiversity, tropical deforestation) affect developed countries directly.
- World population growth and imbalances, as well as health threats (AIDS, epidemics), are now seen as global problems requiring financial and technical assistance from donors.
- International cooperation and the support of donors is necessary to avoid 'public bads', such as crime, drug traffic and terrorism on a regional and global scale.

Altruism, ethical, humanitarian and religious concerns, which highlight the moral obligation of donor countries to assist the poor in developing countries.
- Alleviate human suffering and express solidarity with fellow human beings.
- Helping to cope with natural and man-made disasters through humanitarian and emergency relief.
- Religious proselytism and desire to win converts to a particular faith.

Maintaining stability of the international system, which aims at securing a stable world order to foster the long-term interests of donor countries.
- Maintaining political stability by preventing and containing local and regional conflicts, and by promoting the spread of democracy (supporting peace making and peace keeping initiatives, monitoring and supervising elections, help to strengthen democratic practices and institutions).
- Ensuring world economic stability through policy reforms in developing countries, and through measures to avoid major disruptions of international finance and trade (provide funding to help defuse debt crisis, Mexican peso collapse, East Asian crisis).
- Maintaining social stability in the developing regions to prevent international migrations (programs to reduce population growth, combating poverty, aid to promote human rights and improve the situation of women).
- Showing willingness of rich countries to accept responsibility for assisting the less fortunate in a global society.
- Helping developing countries to improve their participation in international agreements to make them more equitable, stable and effective.

3.4.3 *The skewed structure of financial flows to developing countries*

Taking into account the above outline of the main sources of public and private financial flows to developing countries, we see a structure is now skewed more in favor of highly concentrated and mobile private investments and less towards the long-term development finance needs of developing countries. Moreover, the vastly increased mobility of international capital limits the capacity of most developing country governments to tax capital flows and profits. This makes it difficult to maintain a level of public expenditures commensurate with the growth of social demands, especially in the poorest countries. From this perspective, a possible additional motivation for Official Development Assistance may be to compensate for the negative impact that financial globalization has on economic stability and social cohesion.

3.5 *Other actual and potential sources of development finance*

This account of development finance would not be complete without reference to new possibilities that are emerging. Private foundation grants and new philanthropic initiatives, the Clean Development Mechanism sketched at the 1997 Kyoto meeting of the International Panel on Climate Change (IPCC), and proposals to establish global and regional tax regimes indicate that options to finance development range well beyond the traditional boundaries of private investment and official development assistance. In addition, there are some renewed attempts at commodity price stabilization (Box 2).

BOX 2

Commodity price stabilization: a new approach at the World Bank

The idea of a World Commodities Organization did not seem ludicrous to John Maynard Keynes, one of the main forces behind the creation of the World Bank and the IMF five decades ago. At the time, he wanted a sister institution to bring order to volatile commodity markets. Keynes failed then and subsequent efforts, most notably by the United Nations Conference on Trade and Development (UNCTAD) in the 1960s and 1970s, also failed to materialize in a sustainable way.

The World Bank is considering launching a new initiative, which is sponsored by the International Task Force on Commodity Risk Management in Developing Countries (ITF) and appears to be different from previous attempts to set up commodities stabilization funds. In addition to international agencies, the ITF has also attracted the interest of private firms, such as grain trader Cargill and Crédit Lyonnais, the French bank that has a large commodity-finance arm.

The ITF approach consists in helping small producers in developing countries gain access to financial hedging techniques, such as put options, in order to secure a minimum price for their harvests. If farmers can do that, they need not rely on usurious money-lenders and local banks would be more willing to lend them money at reasonable rates, so they can invest in seeds, pesticides and equipment to improve productivity. However, small farmers are often unaware or suspicious of such instruments and lack the resources to purchase them. Firms and institutions that offer financial hedging products are deterred by the very small volumes farmers want to trade, and by their uncertain creditworthiness.

The ITF aims to help poor farmers overcome such obstacles, without forming a large bureaucracy or spending huge sums to fight the market. It plans to achieve this through capacity building and training programs in farmers' cooperatives and similar organizations. Putting these initiatives in place would require some government subsidies and guarantees. Although figures as high as US $1.5 billion over five years have been mentioned as the possible cost the ITF proposals, it is likely that a few smaller scale pilot projects will be launched by the end of 2000 to test the ITF approach.

Source: *Development News*, (World Bank daily summary of news), August 18, 2000. Available at http://www.worldbank.org/news.

3.5.1 *Private foundations*

Several private charitable foundations have long been involved in international development (e.g. Ford, Rockefeller, MacArthur, Carnegie Corporation, and the Wellcome Trust). The grants provided by these organizations and others are a relatively small component of international development cooperation, but their impact is often magnified because they are able to finance exploratory ventures and to take risks that would be difficult for bilateral or multilateral aid agencies. Non-governmental organizations supported by such grants have also acquired greater prominence and are providing international leadership in some specific fields, particularly in environmental conservation, the improvement of social conditions and human rights.

Private philanthropy has experienced rapid growth over the past two decades. The 'Council on Foundations' reports, for example, that almost half of the 12,000 largest foundations in the United States have been created since 1980. Among some of the more prominent examples are George Soros, Ted Turner and Bill Gates. The *George Soros Foundation* operates through a network of national foundation and societies in more than 30 countries in Central and Eastern Europe, the former Soviet Union and in some developing regions. The affiliated organizations fund and operate activities in the arts and culture, the strengthening of civil society, economic reform and development, education, human rights, legal reform and public administration, and media and information. In 1999 it committed close to US$ 600 million to support these programs over several years.

The *Ted Turner Foundation* supports initiatives in energy, water and forest conservation, as well as in reproductive health, the status of women and girls education. Although most of its activities are focused on the US, it funds projects in Asia and Latin America. In late 1997 it established the United Nations Foundation, and pledged $1 billion over ten years to support selected UN activities. The *Bill and Melinda Gates Foundation*, endowed with nearly $20 billion in Microsoft Corporation stock, is the richest foundation in the world and supports health and educational programs. It has focused on extending the availability of vaccines to the world's poor children to combat hepatitis B, meningitis and pneumonia, and on research and development of new vaccines to prevent malaria, tuberculosis and HIV/AIDS. In 1999 it committed US$ 2.5 billion over several years, about half of which was allocated to international health programs.

These have also been joined by internationally known musicians and media personalities. A series of televised rock concerts in the early 1990s, which were linked to a phone in campaign soliciting pledges from viewers, raised more funds to combat AIDS in Africa than formal pledging conferences organized under United Nations auspices. Towards the end of the 1990s, and in just a few weeks, royalties from Elton John's compact disc issued in memory of Princess Diana generated more than $100 million for campaigns to remove anti-personnel mines in war-torn countries. In 1999 the United Nations Development Program teamed up with a group of media personalities and leading businessmen in the information technology sector to raise funds for development assistance through the Internet. In addition, there have also been proposals to establish lotteries to raise funds for international development activities.

The well established and the new breed of private foundations are building strategic alliances with international organizations, government agencies, private firms and non-governmental organizations in some specific programs. An example of such collaboration is the Global Alliance for Vaccines and Immunization (Box 3).

BOX 3

The Global Alliance for Vaccines and Immunization

The Global Alliance for Vaccines and Immunization (GAVI) was formed in 1999 with the objective of ensuring that every child in the world is protected against vaccine-preventable diseases. The GAVI partners have come together to coordinate and revitalize immunization programs at the international, regional and national levels. The GAVI founding partners include:

- Bill and Melinda Gates Children's Vaccine Program
- International Federation of Pharmaceutical Manufacturers Associations (IFPMA)
- National governments (US, UK, Norway, The Netherlands, Sweden, among others)
- Public health and research institutions
- The Rockefeller Foundation
- United Nations Children 's Fund (UNICEF)
- The World Bank Group
- World Health Organization (WHO)

There are four components to the GAVI strategy: (i) making sustainable immunization services widely available and accessible; (ii) making full immunization coverage a key benchmark in assessing international development efforts; (iii) maximizing the use of the cost-effective vaccines that are already available; and (iv) accelerating the development and introduction of vaccines for diseases that are especially prevalent in developing countries (such as pneumonia, HIV/AIDS, malaria and tuberculosis). In addition to humanitarian goals, the preventive value of immunization reduces the cost of future health care.

GAVI plans to spend at least US $150 million annually up to 2005, even though preliminary estimates indicate that a further US$ 200 million per year would be necessary to fully achieve its goal. In late 1999 the Bill and Melinda Gates Foundation made an initial contribution of US$ 750 million over five years, and President Clinton sent in early 2000 a proposal to the US Congress to provide tax incentives to private pharmaceutical firms that joined this initiative. The future prospects for GAVI appear encouraging. The Alliance invited all countries with an income of less than US$1,000 per capita to express their interest in receiving support from the Global Fund for Children's Vaccines. More than two-thirds of the countries responded by April 2000, detailing their current immunization activities, plans and needs.

However, GAVI also provides an example of the governance problems that are emerging when public sector agencies, multilateral institutions, private corporations, non-governmental organizations and foundations embark in joint efforts. In May 2000 some government representatives expressed their reluctance to provide GAVI with large scale funding until key issues related to transparency and accountability in the use of funds are resolved. In particular they were concerned about balanced participation in the board, rules for appointing board members, statutes and mandates for board members, as well as the specific mechanisms for channeling contributions and managing funds. As the rules for the management of public sector funds are much more stringent and cumbersome than those for private corporations or foundations, such concerns are not surprising.

Source: Web page of the foundation http//www.vaccinealliance.org; *Development Today: Nordic Outlook on Development Assistance, Business and the Environment,* (Vollen, Norway), June 16, 2000.

3.5.2 *The Clean Development Mechanism*

In December 1997 the Parties to the United Nations Framework Convention on Climate Change approved the Kyoto Protocol, which seeks to limit and eventually reduce the emission of greenhouse gases that contribute to global warming. The Kyoto Protocol established a 'Clean Development Mechanism' (CDM) designed to help signatories to the protocol to fulfill their legally binding agreements on greenhouse emissions. In particular, Article 12 specifies that developing countries are to benefit from CDM projects resulting in 'certified emissions reductions' (CERs) and that industrialized countries may use these CERs to comply with their quantified emissions reduction commitments under the Kyoto protocol.

The Kyoto Protocol is the most ambitious environmental treaty ever attempted and if properly designed and implemented, it could simultaneously mitigate the impact of global climate change and lead to the transfer of tens of millions of dollars per year from rich to poor countries. While much remains to be done to make this mechanism operational, there are early indications that developing countries whose forests can absorb greenhouse gases in amounts above their emissions limits could reap substantive benefits from the sale of unused emission rights to industrialized countries and private corporations. Several countries in Latin America and Asia are in the process of preparing proposals to take advantage of the CDM, if and when it is finally launched. The World Bank has started a Prototype Carbon Fund and the Asian Development Bank is providing assistance to its member countries for the preparation of project that could receive CDM financing.

3.5.3 *International taxes*

Proposals to generate resources for development assistance in a predictable and assured way are not new. For example, at the United Nations Conference on Science and Technology for Development held in Vienna in 1979, the Group of 77 proposed the creation of an international science and technology fund based on a tax on international transactions in high technology. As could be expected, this proposal got nowhere in the highly charged international political environment of the 1980s.

In 1972 Professor James Tobin proposed the creation of a small tax on currency transactions as a way of discouraging speculation in short-term foreign exchange dealings, thus minimizing shocks from large currency movements. The underlying logic was that the tax would slow down highly damaging, speculative and short-term capital flows without providing a disincentive to any form of more stable investment. The concept of this mechanism was to tax a 'global bad,' namely instability in financial markets. Other proponents of what has come to be termed the 'Tobin Tax' have extended Tobin's original proposal to include both the tax on the global bad and its application to a global good, namely international development.[31] Calculations made in the early 1990s indicate that a tax of 0.1 percent on currency transactions in the G7 area of business would generate tax revenues well in excess of US $50 billion per year.[32]

The 'bit tax' proposes taxing the flows of information, partly as a way of offsetting the negative impact that the emerging global information society would have on tax revenues. The explosive growth of commercial transactions through the Internet is complicating the tax collection role of government, and may lead to a significant loss of resources to finance public goods. In the mid-1990s Arthur Cordell proposed establishing a 0.000001cent tax per bit of information transferred through long distance lines used by the general public, leased lines used by private entities, and local traffic. Advocates of the bit tax scheme claim that it would transform the taxation system one more compatible with the emerging information

---

31 See, for example, UNDP, 1994, Human Development Report, New York, Oxford University Press.

32 See, for example, Kavaljit Singh, 'Tobin Tax: An Idea Whose Time Has Come', article taken from the website: www.ased.org/resources/global/articles/singh9.htm; Rodney Schmidt, 'Feasibility of the Tobin Tax' by International Economic Analysts (Canadian Department of Finance), January 19, 1995; and Andrew Cornford. 'The Tobin Tax: Silver Bullet for Financial Volatility, Global Cash Cow or Both?', Geneva, UNCTAD /SGO/10, 1995.

society. It is also claimed that the bit tax would serve as a disincentive to 'polluted information' flows or 'congestion' in the web. This issue was explored in 1996 at the European Commission, but generated many negative reactions, particularly from private corporations in the telecommunications and information technology fields.[33]

The 1999 *Human Development Report* prepared by the United Nations Development Program proposed a bit tax in order to finance the 'global communications revolution' which would be truly global. The report calculates that in 1996, the bit tax would have collected US$ 70 billion, more than the total amount of development assistance.

These new (and some not so new) initiatives are potentially of considerable importance to development financing. Some of them point to the forging of powerful strategic alliances for greater effectiveness on specific problems such as child immunization. Potential is one thing, however, and current reality is quite another. The rather limited scale of private foundation resources indicates that they will remain relatively minor players in the development finance, and the uncertainties associated with the Clean Development Mechanism and international tax schemes suggest that they will materialize, if at all, only in the medium to long term. Private finance and official development finance will remain the key factors in development finance during the next decade.

[33] Arthur J. Cordell, *Taxing the Internet: The Proposal for a Bit Tax,* speech delivered to the International Tax Program at the Harvard Law School, February 14, 1997; European Commission, 'Building the European Information Society for Us All', First Reflections of the High Level Group of Experts, Final Policy Report Directorate-General for Employment Industrial Relations and Social Affairs DG V, Brussels, January 1996; European Commission, 'A European Initiative in Electronic Commerce', Communication to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions. COM(97)157; Luc Soete and Karin Kamp, *The 'BIT TAX': the case for further research,* University of Maastricht, 1996; and Federation of Electronic Industries, FEI Position Paper on the 'Bit Tax Proposal'. (Ref ICT/96/1564) November 1996.

4. THE MULTILATERAL DEVELOPMENT BANK SYSTEM

4.1 *Characteristics of and relations between multilateral development banks*

About 25 institutions conform broadly to the definition of a multilateral development bank advanced in the introduction to this report (Table 1), although half a dozen of these - the World Bank Group and the regional development banks - can be considered major players in the international development finance scene. However, several of the smaller subregional banks and funds are quite important for their developing country members (e.g. Andean Finance Corporation, Arab Fund for Economic and Social Development).

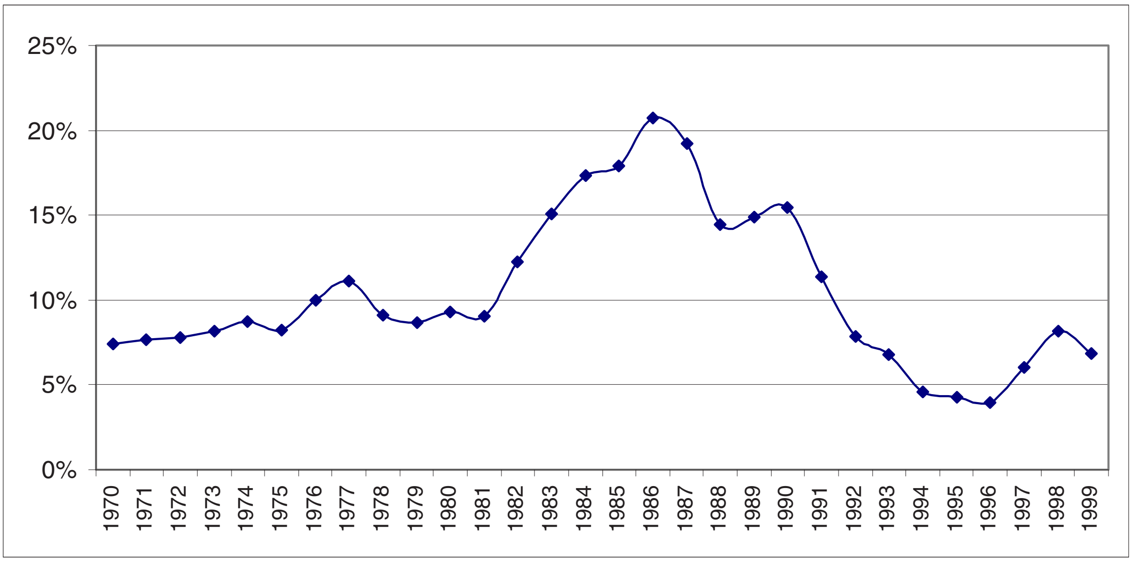
4.1.1 *Some key features of the MDBs*

The percentage of total net resource flows to developing countries accounted for by the major MDBs has varied between 5 and 20 percent during the last thirty years (Figure 13). The peak occurred in the mid-1980s, as the MDBs stepped in to compensate for the abrupt fall in private flows due to the debt crisis of that decade. Net flows from subregional institutions are not included in these calculations, and even though they would probably not add significantly to total net transfers, they play a very important role in a number of countries. The impact of MDB flows to developing countries exceeds the MDB share of total net resource flows. This is not only because of the concentration of private flows and the stagnation of ODA examined in the preceding sections. It is also due to the capacity of MDB flows to mobilize complementary domestic and international resources, and because of value-added contributions in policy dialogue, conditionality and technical assistance.

The share of multilateral flows in total official net resource flows to developing countries increased gradually from about 20-25 percent in the early 1970s to about 50 percent throughout the 1980s. It experienced a sudden surge in the mid-to late 1990s, primarily because bilateral net resource transfers were negative and there was a sudden increase in lending by the MDBs during the Asian financial crisis, mostly of emergency nature.

The World Bank Group is the oldest and largest of the MDBs, and comprises the International Bank for Reconstruction and Development (IBRD), its regular lending window; the International Development Association (IDA), its concessional lending window; the International Finance Corporation (IFC), its private sector financing affiliate; and also the Multilateral Investment Guarantee Agency (MIGA) and the International Center for the Settlement of Investment Disputes. IBRD has a total authorized capital of US$ 188 billion and close to US$ 114 billion in outstanding loans, with equity of US$ 28 billion. (See Table 7 for financial indicators for MDBs).

FIGURE 13
Multilateral official flows as percentage of total net resource flows
(percentages)



Note: **Aggregate net resource flows** are the sum of net resource flows on long-term debt (excluding IMF) plus net direct foreign investment, portfolio equity flows and official grants (excluding technical cooperation). **Multilateral net resource flows** are public and publicly guaranteed multilateral loans include loans and credits from the World Bank, regional development banks, and other multilateral and intergovernmental agencies. Excluded are loans from funds administered by an international organization on behalf of a single donor government. **Official net resource flows** are the sum of multilateral and bilateral net flows. **Net resource flows** (or net lending or net disbursements) are disbursements minus principal repayments.

Source: World Bank, Global Development Finance 2000 (CD-ROM)

The Inter-American Development Bank (IADB) mirrors closely the structure of the World Bank Group, with a regular lending window, a concessional lending window (Fund for Special Operations – FSO) and a private sector financing affiliate (Inter-American Investment Corporation – IIC). The total capital of the IADB is US$ 100 billion, with US$ 37 billion in outstanding loans and equity close to US$12 billion. While the European Investment Bank has also has US$ 100 billion in capital, only about 20 percent of its loans are directed towards developing countries. The authorized capital of the Asian Development Bank (AsDB) is close to US$ 50 billion, and it has US$ 25 billion in outstanding loans and US$ 10 billion in equity. It is rather surprising that the ASDB has about half the capital of the IADB, particularly in view of the size and diversity of the Asian region. The authorized capital of the African Development Bank (AfDB) is US$ 22 billion, less than half of the capital of the AsDB. It has US$ 9 billion in outstanding loans and close to $4 billion in equity. The last of the regional development banks, the European Bank for Reconstruction and Development (EBRD) has an authorized capital of close to US$ 20 billion, US$ 5 billion in outstanding loans and US$ 5 billion in equity.

The subregional MDBs are smaller. In Latin America and the Caribbean, for example, the Andean Finance Corporation (CAF) has US$ 3 billion in authorized capital, US$ 4 billion in outstanding loans and US$ 1.4 billion in equity; the Central American Bank for Economic Integration (CABEI) has US$ 2 billion in authorized capital, US $2.1 billion in outstanding loans and about US$ 1 billion in equity; and the Caribbean Development Bank

(CDB) has US $750 million in authorized capital, US$ 277 million in outstanding loans and about US$ 330 in equity.

TABLE 7
Financial Indicators of Multilateral Development Banks, 1999
(US$ millions)

	IBRD	IFC	CAF	IDB	IIC	AfDB [2]	AsDB [2]	EBRD [3]	EIB [3]	CDB [2]	CABEI	Arab Fund [7,2]
Authorized capital	188 220	2 374	3 000	100 881	703	22 375	48 456	19 641	100 000	750	2 000	2 640
Callable	-176 825	-24	-2 139	-96 544		-19 610	-45 042	-14 478	-94 000	-584	1 635	
Paid-in	11 395	2 350	861	4 338	204 [8]	2 765	3 414	5 163	6 000	166	365	2 166
Assets	230 808	33 456	5 420	64 355	361	12 864	41 653	19 595	201 104	446	3 039	6 109
of which:												
Loans Outstanding net of loans loss provisions	113 668	6 241	4 059	37 385	243	9 026	24 698	4 917	87 974	277	2 126	4 083
Liabilities	202 787	28 112	3 997	52 582	153	9 039	31 590	14 523	181 479	133	1 934	98
of which:												
Borrowings	115 739	12 429	869	39 553	150	7 582	23 744	12 562	337	126	1 059	0
Equity	28 021	5 334	1 423	11 774	118	3 825	10 063	5 072	19 624	333	1 005[10]	6 011
Total Liabilities and Equity	230 808	33 456	5 420	64 355	361	12 864	41 653	19 595	201 104	466	3 039	6 109
Income	9 642	1 506	375	3 194	28	759	1 833	376	9 364	26	215	313
Expenses[1]	7 995	1 256	283	2 626	41	600	1 366	334	8 177	10	166	29
Operating Income	1 647	249	93	568	-13	158	467	43	1 187	15	49	285
Less contribution to special programs	-129	3	0	0	0	16	-3 [4]	0	-120 [5]	0	-15	-15 [6]
Net Income	1 518	246	93	568	-13	142	464	43	1 067	15	33	270
Retained earnings at the beginning of the fiscal year	16 733	2 998	440	4 156[9]	18	1 572	6 496	134	11 557	164	502	3 579
Net income for the fiscal year	1 518	246	93	568	-13	142	464	43	1 067	15	33	270
Retained earnings at end of the fiscal year	17 709	3244	533	4 724	5	1 714	6 961	177	12 624	179	535	3 845

Notes:
1 Includes administrative expenses
2 1998 Financial Statement
3 In Euros
4 Appropriation of guarantee fees to special reserve
5 Transfer to Fund for general banking risks
6 Provision for Technical Assistance and for Arab Academic Fellowship
7 Although not strictly a bank, The Arab Fund operates like one
8 Corresponds to subscribed capital
9 Special Reserve is not included (US$ 2 666 millions)
10 Donations, special contributions and reserves from public sector is included (US$ 202 millions)

Source: Financial Statements of the institutions

The subregional banks and funds operating in the Arab region are a special case, for there is close coordination between the four regional banks and funds (the Islamic Development Bank, the Arab Bank for Economic Development in Africa, the Arab Fund for Economic and Social Development and the OPEC Fund), and the three bilateral development assistance agencies (the Saudi Fund, the Kuwait Fund and the Abu Dhabi Fund). The largest of these are the Islamic Development Bank, with about US$ 7 billion in authorized capital, and the Arab Fund for Economic and Social Development (AFESD) which operates like a bank but has a very different financial structure to that of the MDBs. All of its capital has been paid in, and it has been significantly augmented with reserves from retained earnings (for a total equity of about US $6 billion). It is authorized to borrow in the capital markets but has not yet done so, although this is now under consideration. For its part, the Arab Bank for Economic Development in Africa (BADEA) has close to US$ 1.1 billion in capital. As a whole, the seven institutions channel about US$ 4 billion per year to the Arab developing countries.

4.1.2 *Interactions between the MDBs*

The institutional relationships between the MDBs are complex, involving combinations of cooperation, rivalry and competition. There have been formal cooperation agreements between senior managers[34] and there are cases where some sort of division of labor has been agreed, relationships have often been competitive and even combative. For example, there have been instances in which regional banks walk away with projects that World Bank staff had been developing for some time, and situations in which subregional banks compete for projects with regional development banks and the World Bank. These situations seem to arise more in the smaller middle and low income countries, where the number of potential bankable projects may be limited, that in the larger countries that can absorb MDB loans rather easily.

The regional banks frequently follow many of the World Bank's operational leads but in some cases can offer more attractive financial terms and conditions, as expressed in lending spreads and loan charges (Table 8). Differences in administrative costs between some of the major MDBs are also quite visible, with the Asian Development Bank showing considerably lower costs in thousands of dollars per projects approved, per project under administration, per US$ 1 million committed and per US$ 1 million disbursed than the World Bank or the Inter-American Development Bank. These two latter institutions show approximately the same values for these performance indicators. It is clear that if the Asian Development Bank evolves in the direction of more complex social and capacity building operations (i.e. fewer large physical infrastructure projects as a percent of total lending), it will have to increase its administrative costs (Table 9).

In some cases, the regional development banks have built close working relations with the subregional banks. For example, the IADB provides resources to the Caribbean Development Bank to on-lend to small island countries of the Caribbean that are not IADB members. It also provides technical assistance and financial resources to the Central American Bank for Integration and, more recently, to the newly-created North American Development Bank. Relations are somewhat strained between the IADB and the Andean Finance Corporation, primarily because of the aggressive expansion of the latter, which includes the possibility of transforming itself into a Latin American Development Bank at some stage in the future.

[34] For example, the African Development Bank and the World Bank recently signed a formal memorandum of understanding.

TABLE 8
Comparative MDB Loan Charges
(In Basis Points over US $LIBOR, 6m)
(January 1, 2000, 1 basis point = .01%)

	IBRD VSCLs	IBRD FSLs	IADB[1]	AfDB	EBRD	ADB[1]
Contractual spread	75	80	50[2]	50	100	60[2]
Benefit of Sub LIBOR[3] Funding Cost	-33	-25	-22	-5	-	-
Waivers	-25	-25	-	-	-	-
Net Spread over LIBOR **(I)**	17	3	28	45	100	60
Commitment charge	75	85[4]	75	75	50	75[5]
Waiver	-50	-50	-	-50	-	-
Net Commitment Fee	25	35	75	25	50	75
Spread Eqv. Of Commitment Fee [6] **(II)**	21	26[7]	63	21	42	32
Contractual Front-end Fee	100	100	100[8]	0	100	100
Spread Eqv. Of Front-end Fee[6] **(III)**	26	26	23	0	26	26
Total Spread-Equivalent over LIBOR (I+II+III)	**64**	**82**	**114**	**66**	**168**	**118**

1 Only a small portion of USD lending by IABD and ADB is priced off USD LIBOR.
2 This is a variable spread. The spread shown for ADB was changed as of January 1, 2000. The previous spread was 40 basis points.
3 The IBRD average cost margin (sub-LIBOR spread) shown is for USD SCL rate settings from January 15, 2000 through July 15, 2000. Sub-LIBOR spreads for IADB and AfDB shown are the current sub LIBOR spreads for USD.
4 For the first four years, an additional commitment charge risk premium of 10bp is charged on the undisbursed amount over and above the contractual commitment charge.
5 The commitment charge is applicable to the following proportion of loan amount less the cumulative disbursements: 15 percent in the first year, 45 percent in the second year, 85 percent in the third year and 100 percent in the fourth year and beyond.
6 Spread-equivalent computations for commitment charge and front-end fee use an average IBRD disbursement profile derived in FY99 using historical sector and instrument specific disbursement profiles. The profile so derived does not factor in events such as loan cancellations, prepayments and protracted debt service problems faced by the Bank. Typical repayment terms used are as follows: Final Maturity: 17 Years; Grace Period: 4 Years; Payment Term: Equal Payment of Principal. Disbursement profiles and payment terms vary across MDBs and hence spread-equivalent charges would vary based on the disbursement profile and payment terms used.
7 To account for the commitment charge risk premium an average spread of 5 basis points was added to the normal commitment charge spread equivalent.
8 The front end fee is collected over a four-year time horizon: 25 percent in each year.

Source: The World Bank, http://www.worldbank.org, Financial Products and Services

Borrowers often perceive the regional and subregional banks as being closer to their concerns and interests, a perception reinforced by the fact that their staff members are mainly from the region and are supposed to have a better understanding of the political and social realities of their respective regions. Closeness to their borrowing member interests, however, may be fraught with dangers when there are no financial and operational restraints. For example, when borrowing members have dominated MDB Boards and operations - the Central American Economic Integration Bank and the African Development Bank through the early 1990s - political interests and negotiations among members may have prevailed over lending discipline. These two institutions experienced a marked deterioration in portfolios and in financial standing, but this does not appear to have been the case for the Arab sub-regional financing institutions.

In 1994, the Development Committee of the World Bank and the IMF established a Task Force on Multilateral Development Banks to undertake, for the first time, an assessment of the capabilities and coordination among the World Bank and the four regional development banks. The Task Force Report, released in March 1996, called for intensified coordination at three levels: at the country level, at the working level, and at the level of the chief executives. The stated objectives of the three levels of coordination were to ensure greater consistency of views, to build complementary initiatives and to avoid duplication.

TABLE 9

Administrative Costs and Performance Indicators for Selected MDBs, 1995-1999

Indicators	Actual				Estimated	Projected
	1995	1996	1997	1998	1999	2000
Administrative Expenses per Project Approval ($000)						
IBRD/IDA	5,330	4,677	4,873	4,094	4,057	4,279
ASDB	2,157	2,354	2,608	3,800	3,684	2,971
IADB	4,479	4,314	4,095	3,511	4,000	3,922
Administrative Expenses per US$ 1M Commitment ($000)						
IBRD/IDA	57	56	61	41	42	45
ASDB	31	34	20	33	41	35
IADB	41	47	54	33	35	49
Professional Staff per Project Approval ($000)						
IBRD/IDA	16.5	14.3	14.9	13.4	14.0	n.a.
ASDB	8.1	8.4	9.0	12.8	11.9	9.6
IADB	16.1	15.2	14.4	12.4	13.9	14.3
Administrative Expenses per Project Under Administration ($000)						
IBRD/IDA	740	682	659	661	659	672
ASDB	335	427	429	446	480	490
IADB	808	752	748	652	664	624
Administrative Expenses per US$ 1 Million Disbursements ($000)						
IBRD/IDA	70	62	59	47	50	45
ASDB	49	48	29	29	38	35
IADB	61	73	60	50	39	49

Source: Asian Development Bank

Note: The data on the performance indicators should be interpreted with abundant caution as they cannot meaningfully reflect inter-institutional differences in operations and circumstances

These recommendations, now roughly five years old, bear directly on issues of enhanced partnership between members of the family of MBDs and have a strong bearing on financial issues of efficiency and on political sustainability. The general view, however, is that the remain largely unimplemented. Regular meetings of top officials from some MDBs have began to take place, but they are still far from yielding operational results. The preparation of Comprehensive Development Framework and Poverty Strategy Reduction papers may help considerably in achieving coordination among all donors, including MDBs at the country level, but they have not yet done so in a significant manner.

4.2 *Changing constituencies and multiplicity of MDB stakeholders*

Because of their special financial structure and the variety of roles they play in the development process, MDBs are a natural point of convergence for demands from many different quarters. Table 10 provides an illustrative list of the multiplicity of stakeholders and constituencies concerned about the operations the MDBs. MDBs have as many as seven major groups of constituencies, although all constituencies are not involved to the same degree in all MDBs. The World Bank clearly has to deal with all of the constituencies, while the smaller subregional MDBs deal with only a few of them.

MDBs are owned by government shareholders and must, therefore, respond to their expressed preferences. Shareholder perceptions, however, are, in turn, influenced by domestic constituencies, particularly in the non-borrowing countries. In addition to shareholders, the traditional constituencies for the MDBs have been groups and individuals that may be grouped into three categories. A first grouping has been geopolitical, concerned with Cold War containment and viewing development as an antidote to revolution. A second grouping has involved private businesses mainly interested in procurement from MDB-financed projects. The third grouping has been the broad spectrum of organizations and individuals concerned with improving the quality of life of the poor. The end of the Cold War eliminated most of the national security constituency – the first constituency. The transition in the 1990s to policy based lending, privatization and competitive bidding for public works has diminished much of the second, - the private firms. Apart from direct shareholders, this leaves the MDBs with just one of its major, traditional constituencies: those with a professional or personal interest in development. Included here are, for example, churches and organized religious groups, national departments of finance and foreign affairs, development agencies, a broad coalition of non-governmental organizations (NGOs), and individuals of myriad backgrounds with interest in the development agenda and in global environmental, health and labor issues. Although this remains a very broad and potent constituency, it is nevertheless considerably less broadly based than in earlier eras.

Some emerging constituencies may provide additional support for MDBs. Regional approaches to problem solving, for example, responding to natural disasters, fighting against health epidemics, peace building and reconstruction, and, in general, the provision of public goods have begun to attract the attention of a variety of stakeholders, from non-borrowing shareholders willing to attach bilateral aid to MDB programs to NGO activists interested in the impact of MDB operations in their fields of concern. Other potential new constituencies include socially and environmentally concerned private sector willing to forge partnerships with MDBs and other agencies to strengthen social capital formation and environmental stewardship, which they consider a positive development for business.

Stakeholders and constituencies have become more differentiated during the last decade, both between and within the seven categories indicated in Table 10. This implies that MDBs now face a multitude of pressures from different quarters, at a time when some of its traditional constituencies are changing and new ones are slowly emerging. There are the circumstances in which MDBs are being challenged to harmonize a increasingly wide variety of diverging and often conflicting interests. In attempting to respond to this, some MDBs, most notably the World Bank, have opened numerous avenues of consultation with NGOs and have attempted to respond to their views and concerns. This has been successful, at least to a reasonable extent (especially in the environment fields), but many single-issue NGOs remain implacably confrontational, escalating demands at the slightest signal that their initial concerns may be addressed. The absence of clear rules and procedures to ensure the public accountability of NGOs makes it especially difficult to find points of reconciliation between such groups and the traditional stakeholders of the MDBs. Balanced against this is the fact that a number of MDB-NGO committees set up during the 1990s have worked in a collaborative way to address some of the shortcomings of MDB operations, particularly in areas that have an impact on human rights and environmental issues. The challenge for senior management and Executive Boards of MDBs is to distinguish legitimate signals and concerns amidst a cacophony of different voices.

TABLE 10

An illustrative list of MDB stakeholders and constituencies

1. Shareholders a) Non-borrowing countries i) Major shareholders ii) Minor shareholders b) Borrowing countries i) Least developed countries ii) Other low income countries iii) Lower middle income countries iv) Upper middle income countries v) High income countries vi) Transition economy countries
2. Other development assistance agencies a) Multilateral development banks b) Bilateral assistance agencies c) United Nations organizations d) Regional organizations e) Private foundations
3. Financial markets a) Investors in MDB paper b) Investment banks working with MDBs c) Rating agencies
4. Private firms and corporations a) Commercial banks that deal with developing countries b) Funds investing in developing countries c) Suppliers of goods and services for MDB projects d) Foreign direct investors
5. Academic and policy making institutions (research, education, policy, information)
6. Non-governmental and advocacy organizations a) Large international NGOs b) Local NGOs
7. MDB staff (differentiated by employment status, seniority and professional affiliation)

In spite of this growing diversification of constituencies, however, the ‘owners’ of the MDBs are their shareholders. They are by far the most important and they ultimately determine both the margins for change and what happens to MDBs. Table 11 indicates the main shareholders in nine of these institutions. Sweden, Finland, the United Kingdom and Canada are the only countries that belong to six of these MDBs, while the United States, Japan, Belgium, France, Germany, Italy, The Netherlands, Norway, Spain and Switzerland belong to five. The United States is the largest shareholder of the MDBs in which it participates, with the exception of the African Development Bank where Nigeria has a larger share. Nevertheless, the combined voting weight of the smaller non-borrowing shareholders - which includes the Nordic countries, Canada, The Netherlands, Italy and Spain - could play an increasingly significant role in helping to shape the future of MDBs.

TABLE 11
Voting Power and Membership of the Main MDB Shareholders
(Countries participating in three or more MDBs and Russia)

Country	*Percent of total shares held*								
	IBRD	**IADB**	**AfDB[1]**	**AsDB**	**EBRD**	**IDB**	**CAF**	**NIB**	**CDB**
Australia	1.54			5.07	0.51				
Belgium	1.82	0.22	0.58	0.62	2.34				
Brazil	2.08	10.8	0.41				1.62		
Canada	2.80	4.00	3.20	4.61	3.5				9.05
China	2.80		0.98	5.60					5.47
Finland	0.55	0.16	0.45	0.62	1.29			20	
France	4.33	1.90	3.20	3.24	8.76				5.47
Germany	4.52		3.51	3.87	8.76				5.47
India	2.80		0.22	5.51					
Indonesia	0.95			4.79		3.06			
Italy	2.80	1.90	2.08	1.82	8.76				5.47
Japan	7.91	5.01	4.67	13.09	8.76				
Mexico	1.18	6.92			0.15				2.80
Netherlands	2.22	0.34	0.68	1.18	2.55				
Norway	0.64	0.1	1.01	0.62	1.29			20	
Russian Federation	2.80				4.11				
Saudi Arabia	2.80		0.20			24.36			
Spain	1.49	0.03	0.53	0.62	4.06				
Sweden	0.95	0.29	1.34	0.62	3.34			20	
Switzerland	1.67	0.47	1.27	0.82	2.34				
United Kingdom	4.33	0.96	1.46	2.01	8.76				9.05
United States	16.49	30.03	5.67	13.09	10.28				
Venezuela	1.28	5.76					26.80		2.80

Notes: [1] The largest shareholder of the African Development Bank is Nigeria, which holds 9.725 percent of the shares.
Source: Annual Reports and web sites of each MDB.

4.3 *Some aspects of the evolving roles of the MDBs*

As we have seen, the MDBs have remained anything but static over their lifetime. Their importance as financial intermediaries in relation to other sources of flows to developing countries has fluctuated over time, as indicated earlier in Figure 14. They have grown, their range of products and services has expanded, their roles in the transfer of financial resources have experienced major shifts, and their interactions with stakeholders have also been transformed. It may be said that they have been reinventing themselves as the needs of their clients have changed.

4.3.1 *Changes in the operations of MDBs*.[35]

In their early years, the 1950s and 1960s, with the World Bank taking the lead, MDBs were the primary source for investments in power generation, transport and water supply, as well as some large-scale industrial projects in the developing world. Industrial investment was financed directly by the MDBs as well as indirectly, through domestic development finance institutions, many of which they helped to establish.

A period of major diversification started in the late 1960s with emphasis on integrated rural development and the financing of agriculture and the social sectors (such as education, health, nutrition and population). The diversification continued when the oil price shocks of the 1970s led MDBs to focus some of their attention on hydrocarbon and other energy resources in the developing world. The debt crisis of the early and mid-1980s brought about another major shift, from financing mainly projects in various economic sectors to an increasing proportion of fast-disbursing balance-of-payments support under structural and sector adjustment programs. These were aimed at wide-ranging economic reform and at improving the quality of economic management at sector and economy-wide levels. In effect, however, they provided essential liquidity to debt-ridden developing countries, allowing them to service their debts with commercial banks.

With the 1990s, came new pressures for operational shifts into such areas as governance, gender, environmental impact, human rights of displaced populations. In addition, the transformations experienced by Eastern Europe and the former Soviet Union added a new set of clients to the World Bank and the EIB, and prompted the creation of the EBRD. During this decade, MDBs were also asked to undertake the provision of a broad range of regional and global public goods (e.g. global environmental protection, peace building)

4.3.2 *The evolution of net transfers and countercyclical lending*

The formal definition of the graduation of a country from the regular loan windows of the MDBs is made terms of income per capita levels. Whatever the per capita level, however, as borrowing countries develop (i.e. increase their standards of living, improve their economies and gain access to private capital markets), MDB financial resources become less important for them. The direction of the financial relationship then changes - the country receives little if any new funding from the MDBs while paying back outstanding loans. This places them in a negative net transfer position with the MDBs. This happened as the reconstruction financing function of the IBRD was superseded by access to private capital markets in countries like Japan in the mid to late 1950s, and in other high-income countries in later decades.

For many middle income countries, the balance of payments pattern of the past three decades has demonstrated high degrees of volatility. Huge fluctuations have been experienced as a result of changing commodity prices or interest rate spikes in industrial countries. Across many countries, the result has been an inability to grow in a sustained manner and at rates sufficient to increase general living standards and reduce poverty. Under

---

[35] For a detailed analysis of changes in the operations of the MDBs over time see: Roy Culpeper, *The Multilateral Development Banks: Titans or Behemoths?*, Ottawa, The North/South Institute, 1997.

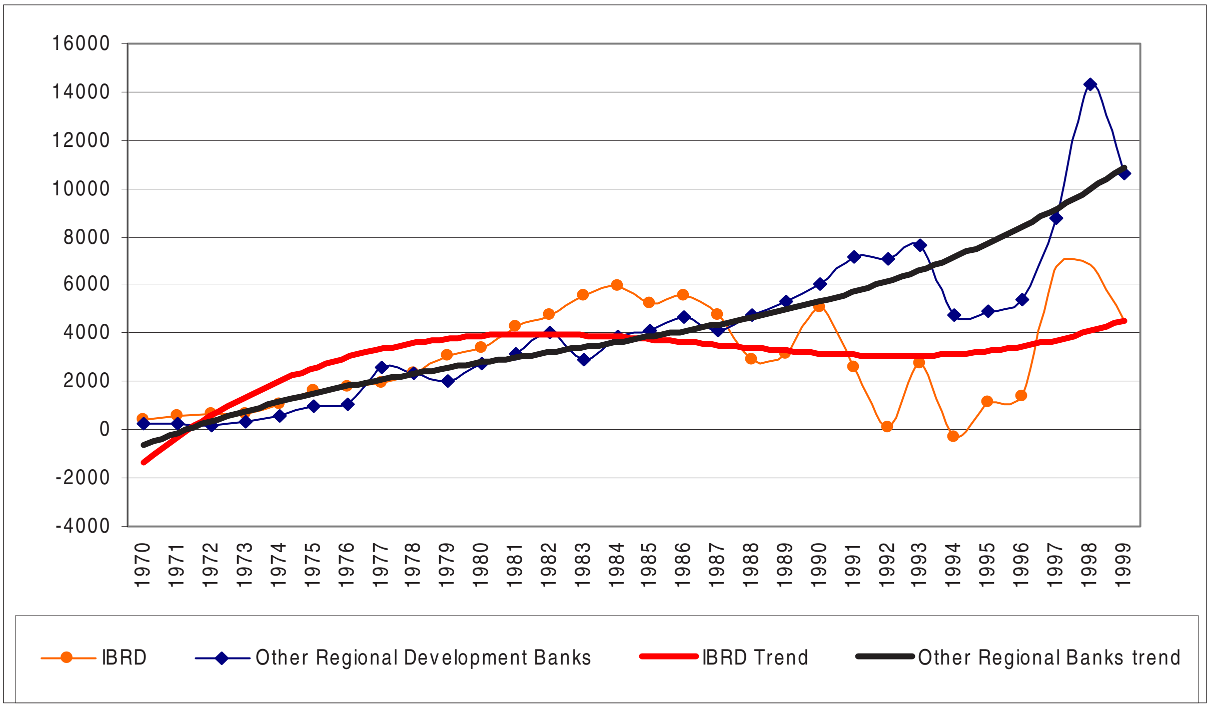
these circumstances, negative net transfers can pose serious problems to economic viability. In addition and as already indicated, even relatively more advanced developing countries with access to capital markets may need, at some stage, support from the MDBs. Given these factors, it has been argued that the loan portfolios of MDBs should grow steadily so as to maintain positive net transfers with borrowing members: meeting shareholder expectations with respect to poverty reduction is seen as not consistent with negative net disbursements. However, such a stance implies that MDBs would require a continuing series of capital increases, so as to accommodate growth in lending without jeopardizing financial integrity.

An alternative perspective, which needs to be explored in more detail than it is possible in this report, would view the net transfer situation of the MDB system as a whole and region by region. From this point of view, as the portfolio of an MDB matures and moves into a lower positive transfer position - and maybe into a negative net transfers - with a group of countries, other MDBs would move to a positive net transfer situation to compensate for it. For example, as the World Bank has reduced its positive net transfers as a whole (Figure 14) and to the various regions (Figure 15), the regional development banks have increased theirs.

FIGURE 14

Total Net Transfers of IBRD and Regional Banks to developing countries

(US$ million)



Note: Multilateral net transfers are defined as disbursements minus total debt service payments (principal plus interest).

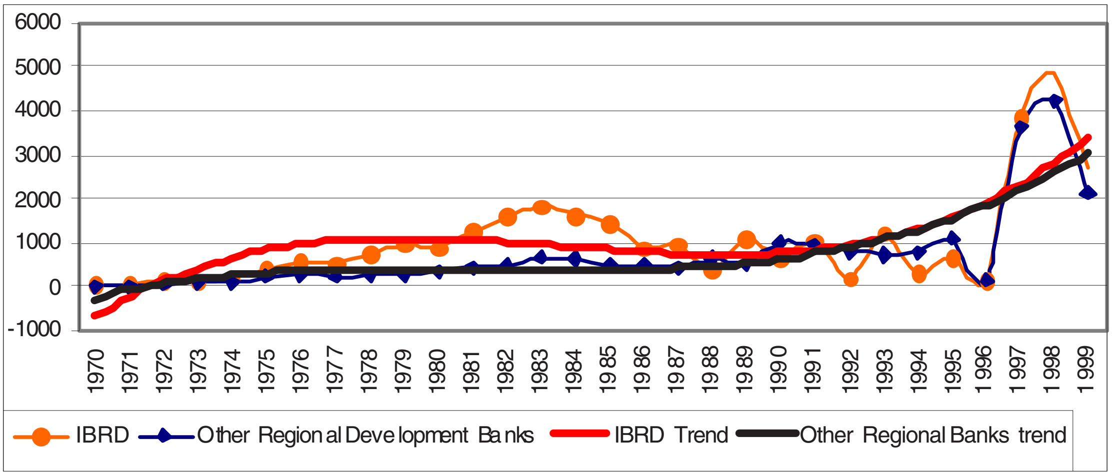
Source: World Bank, Global Development Finance 2000 (CD-ROM)

FIGURE 15

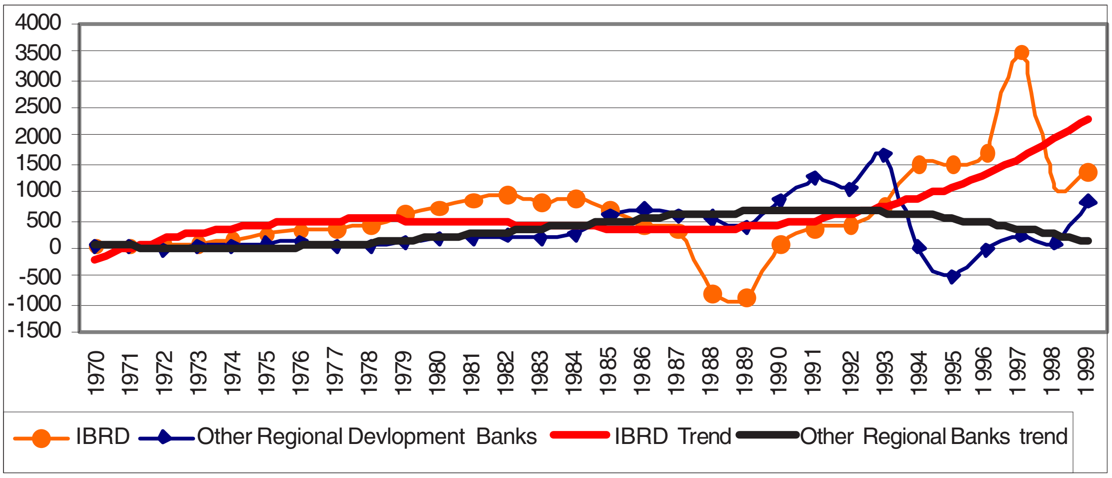
Multilateral Bank Net Transfer to developing countries by regions

(US $ million)

East Asia & Pacific



Europe & Central Asia



Latin America & Caribbean

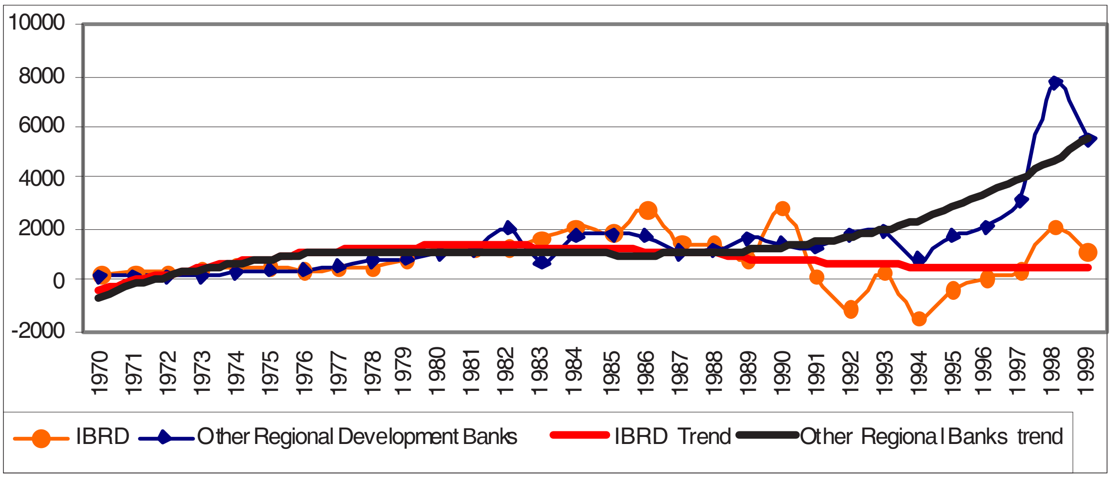
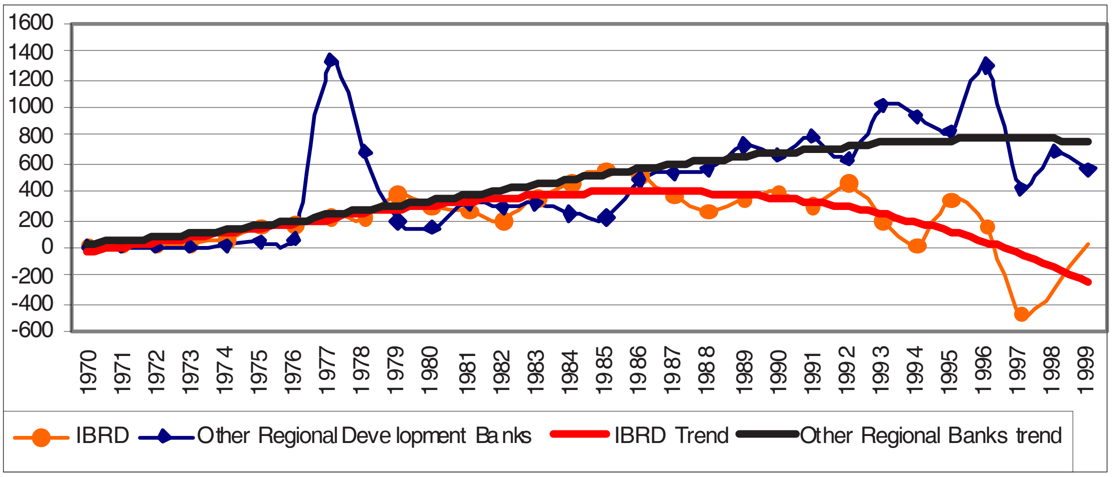
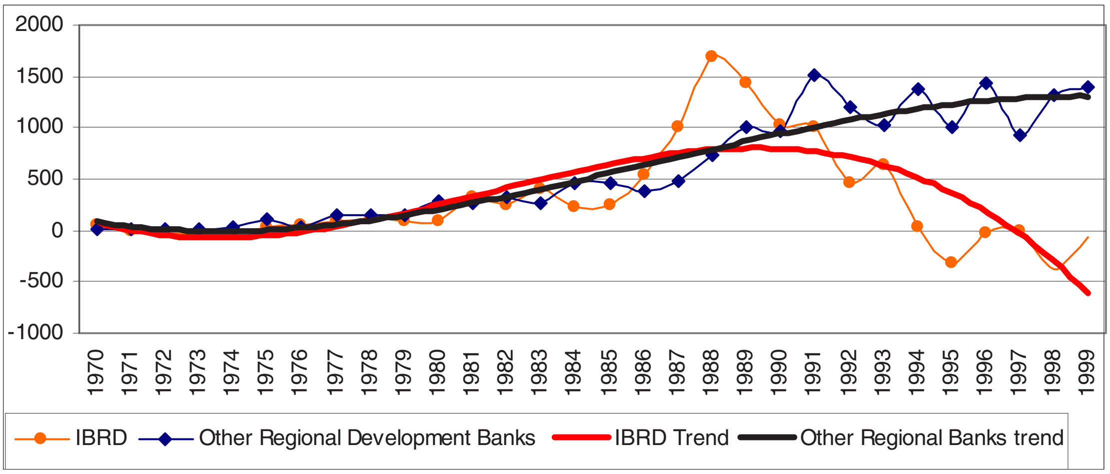


FIGURE 15 (continued)

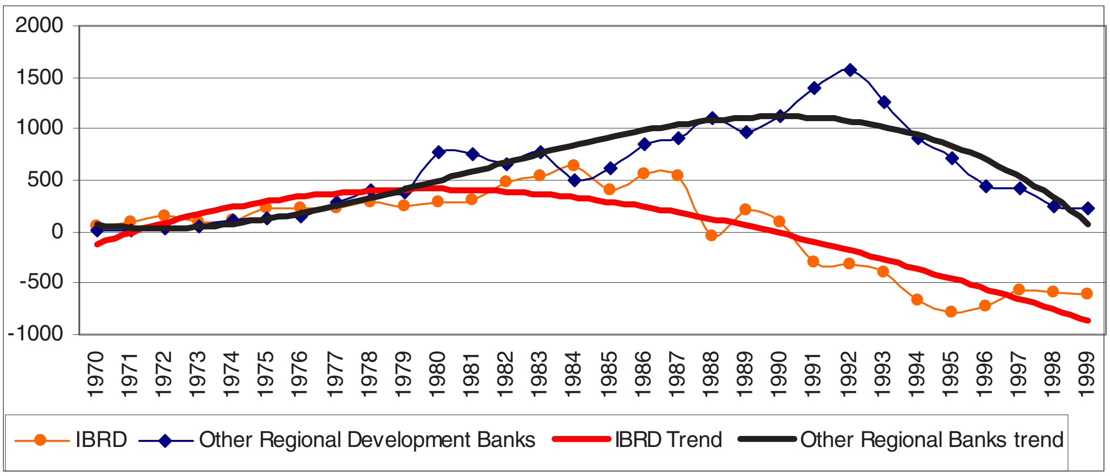
Middle East & North Africa



South Asia



Sub-Saharan Africa



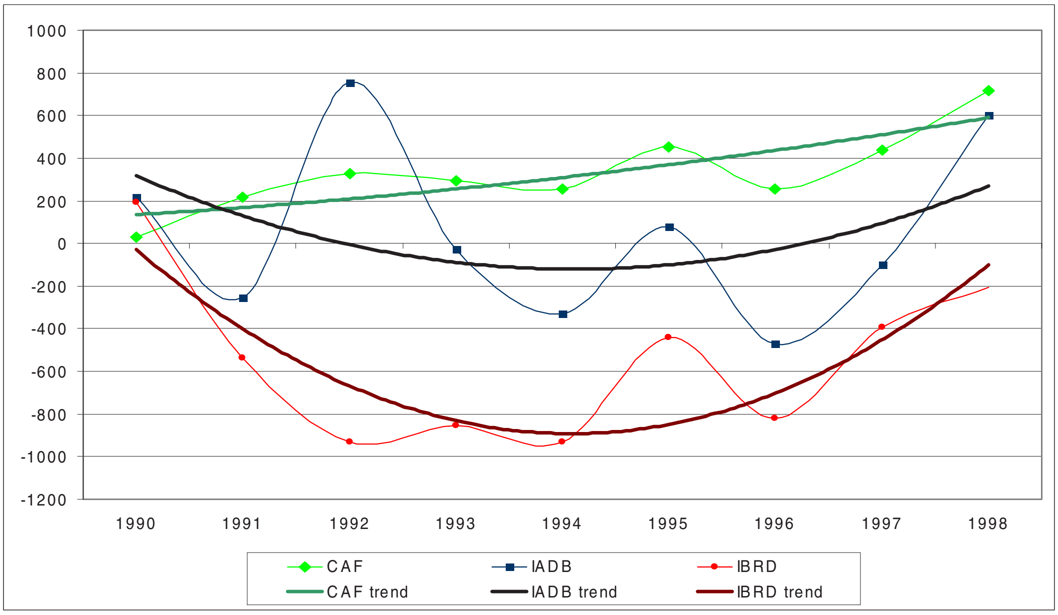
Source: World Bank, Global Development Finance 2000 (CD-ROM)

An example of the perspective that can be obtained from looking at the MDB system as a whole comes from the Andean region and can be clearly seen in Figure 16. The Andean Finance Corporation has been in a relatively high positive net transfer situation throughout most of the 1990s, whereas the situation of the World Bank has been exactly the opposite. The IADB has fallen between the two, with net flows varying between a slight negative and a slight positive. This explains why some government authorities in this region are paying greater attention to relations with CAF.

As a strictly financial rationale recedes with groups of countries and MDBs move into a negative net transfer position, other products and services may become more relevant (e.g. management services, insurance provision). Such products and services would need to be carefully priced, but have the potential both to provide essential development assistance and to maintain relevance in the relationship between the MDBs and an important class of shareholders.

Another issue related to net flows is the question of countercyclical lending by the MDBs. As indicated earlier (Figure 11), concessional disbursements to very poor countries have, in general, played an important role in providing resources at times of crisis and low economic growth. An important countercyclical role is also played with middle and higher income countries experiencing severe disruptions in their relations with capital markets. This was the case during the Asian crisis when the World Bank and the Asian Development Bank increased their loans to countries such as Thailand, the Republic of Korea and Indonesia. For example, in late 1997 the World Bank agreed to provide about US $10 billion - about half of its total annual lending volume - to South Korea, of which nearly US $3 billion were disbursed during the first quarter of 1998 (this compares with a total of US $7.3 billion that the World Bank group provided to South Korea over the 27 years between 1963 and 1990). In addition, South Korea received a $ 4 billion loan from the Asian Development Bank (AsDB), 43 percent of its total 1997 lending volume, as part of the IMF-led rescue package. The countercyclical nature of MDB lending is also evident in the opposite direction: after 1994 the annual rate of growth of AsDB lending declined with the increasing rate of growth of net private lending flows.

FIGURE 16
Total net transfers of IBRD, IADB and CAF to Andean countries*
(US$ million)



Andean countries include: Bolivia, Colombia, Ecuador, Peru and Venezuela.
Source: World Bank, Global Development Finance 2000, (CD ROM)
Corporación Andina de Fomento

4.4 *Financial vulnerability and capital adequacy of MDBs*

An adequate capital and financing structure is fundamental for MDBs to protect their financial integrity, maintain credibility in financial markets and the political support of shareholders, achieve resource mobilization, and meet the purposes of capacity building, knowledge brokering, and provision of public goods. The MDBs have been among the most successful of institutional innovations in large measure because of the financial resource mobilization function.

Central to a sound capital and financing structure is the effective management of risk. The sources of financial risk and vulnerability are different in regular, concessional and private sector operations.

4.4.1 *Regular lending windows*

There are three interrelated sources of risk for the regular lending windows of MDBs: (i) *political*, which refers to the relevance of MDBs to their shareholders and the support they receive from them; (ii) *market*, which refers to the ability to raise funds in capital markets on appropriate terms; and (iii) *portfolio*, which refers to the concentration and quality of loans, as well as to the impact of global financial shocks and contagion effects.

International, region and country specific shocks have an impact on MDBs through these interrelated sources of risk. Changing political circumstances may affect the willingness of key non-borrowing countries to support the MDBs (through capital increases, replenishments, and other measures). Financial crises may make investors in international capital markets more cautious and create hesitation about investing in MDB bonds. Adverse developments in the international economy cause difficulties for key borrowing countries and place them in non-accrual status. The concentration of lending in a few large countries makes MDBs more vulnerable to country specific risks. Natural or man-made disasters can exacerbate each and every of these sources of risk.

The management of these risks to the regular lending window of the MDBs depends on the adequacy (i.e. appropriate level and structure). Until quite recently, discussions about MDB capital adequacy centered principally on the very conservative 'one-to-one' gearing ratio by which MDB lending cannot exceed their total capital (which includes paid-in and callable capital as well as reserves). However, callable capital is to be used only in the unlikely event of massive defaults which, if they occurred would likely lead to closing affected MDBs. Thus, more recently the notion of 'risk bearing capacity' has been adopted as a more operational notion and realistic test of capital adequacy. In broad terms, this notion refers to the capital needed to withstand financial shocks and to continue operating as a viable institution. In the case of the World Bank, this would mean that, following a major non-accrual shock, and after ceasing to transfer net income for other uses (IDA, grants, HIPC), the Bank would still have the capacity to support loan growth (positive net loan disbursements) at the historical average of about 3 percent per annum, and maintain its AAA credit rating.

Instead of focusing on total capital, the risk bearing capacity approach to capital adequacy uses indicators such as the equity-to-loans (E/L) ratio, defined as 'reserves plus usable paid-in capital divided by loans outstanding and disbursed plus the present value of guarantees minus provisions for loan losses'. Table 12 provides information on the risk-bearing capital ratios for several MDBs. Another indicator used by rating agencies, which have consistently assigned an AAA rating to the World Bank and to other MDB, is the ratio of equity capital plus callable capital from AAA or AA shareholders, divided by the total risk assets (defined as loans to borrowing countries with ratings below investment grade). This ratio should be maintained above 100 percent to be considered adequate.

In financial management terms, the system requires that reserves be increased immediately in the face of any downgrading of an MDB portfolio, and in particular when borrowing members risk moving into a non-accrual status. This means the allocation of a larger share of net income to reserves. Net income, however, is obtained from operating income after deducting administrative expenses and interest paid to bondholders and is also used to make transfers to concessional windows, to provide grants, and to fund HIPC. The net effect of placing a larger share of net income into reserves, therefore, would be to maintain financial credibility by 'crowding out' development goods and services (i.e. capacity building, institutional development, knowledge brokering, and provision of public goods.

TABLE 12
Risk-bearing capital ratio for selected MDBs, 1999
(US$ millions)

	Loans Outstanding net of LLP	*Paid-in*	**Retained earnings at end of the fiscal year**	**Risk-bearing capital ratio***
IBRD	113 668	11 395	17 709	3.91
IFC	6 241	2 350	3244	1.12
CAF	4 059	861	533	2.91
IDB	37 385	4 338	4 724	4.13
IIC	243	204[1]	5	1.17
AfDB[3]	9 026	2 765	1 714	2.01
AsDB[3]	24 698	3 414	6 961	2.38
EBRD[4]	4 917	5 163	177	0.92
EIB[4]	87 974	6 000	12 624	4.72
CDB[3]	277	166	179	0.80
CABEI	2 126	365	535	2.36
Arab Fund[3]	4 083	2 166[2]	3 845	0.68

* Ratio between the Loans Outstanding net of Loan Loss Provisions (LLP) and the sum of paid-in plus the retained earnings at the end of the fiscal year.
1. Corresponds to subscribed capital
2. Corresponds to capital reserve
3. 1998 Financial Statement
4. In Euros Source: Financial Statements of the institutions

4.4.2 *Concessional lending windows*

There are two sources of risk for the concessional lending windows of MDBs: (i) *political*, which refers to the support of donor countries; and (ii) *portfolio*, which refers to the ability of borrowers to pay the loans back.

All MDBs currently face restrictions regarding the availability of resources for their soft loan windows. The extent of the restrictions may call into question the future of concessional lending by MDBs. The best that could probably be expected in the near term is that the total volume of development assistance, both from multilateral and bilateral agencies, would remain at its current level in nominal terms, which implies a gradual decline in real terms. However, these loans are inadequate to assist poor countries to meet internationally agreed targets in poverty reduction and social improvements. As indicated in section 3, development assistance is declining for several reasons: the end of the Cold War has diminished its strategic importance, public opinion in donor countries has become more skeptical about its effectiveness, and governments in these countries are increasingly preoccupied with domestic issues while trying to limit fiscal outlays. As a consequence, support for the concessional lending windows of MDB is diminishing in many donor countries.

Two other issues that bear on the adequacy of concessional lending resources are first the impact of the HIPC initiative (Section 4.7) on donor support for concessional window replenishments, and secondly, whether poor countries will be able to grow at rates that will lead to significant poverty reduction, particularly if after debt relief external resources are not made available in the amount and terms required. The replenishment negotiations of the Fund for Special Operations of the Inter-American Development Bank provide an illustration of the political complexity of the issues involved in making concessional resources available to the MDBs and their poor country borrowers (Box 4).

4.4.3 *Private sector lending windows*

There are two main sources of risk for the private sector lending windows of the MDBs, which are usually much smaller than their regular or concessional windows (with the exceptions of the EBRD and the EIB): (i) *market* which refers to the ability to raise funds in capital markets on appropriate terms; and (ii) *portfolio*, which refers to the performance of their equity holdings in private firms and their investment projects. The private sector operations of MDBs are rather limited, and they do not appear to face the same degree of political risk as the regular or concessional lending windows. However, in spite of the fact that private sector windows catalyze additional private flows and provide comfort to private investors, they have been accused in some political quarters of competing with and ‘crowding out’ the private sector. Thus far at least, these views have not carried much weight. Shareholders by and large support these windows so long as they do not require large resources.

4.5 *Sources and uses of net income: their financial and operational implications*

The growing and conflicting pressures faced by MDBs find a clear expression in the management of net income. Achieving an appropriate balance between the three main functions of MDBs involves difficult decisions on the size and the allocation of net income. First, there is the need to use net income to *increase reserves and strengthen their financial position and risk-bearing capacity*. Second, a shift to more complex operations and engagements with stakeholders requires more and better trained staff, as well as a larger presence in the field, both of which *increase administrative expenses* and reduces the margin left after subtracting these from operating income (less interest paid and related charges). Third, a portion of net income is needed to make *transfers to the soft loan windows for concessional lending* and to *provide grants* to cover the cost of public goods and special operations such as emergency relief (both of which also increase administrative costs). Finally, some MDBs are planning to *use net income to cover part of the costs of their participation in the Highly Indebted Poor Country* (HIPC) initiative.

BOX 4

Resources for the Fund for Special Operations (FSO) at the Inter-American Development Bank

In December 1998 the Board members of the Inter-American Development Bank reached an agreement on concessional resources. This required an elaborate set of compromises among Board member, which were closely related to negotiations on how to fund the IADB participation in HIPC. The final agreement, reproduced below, stipulated that IADB borrowing members would convert much of their local currency contributions to FSO (which had been used to fund operations in their own countries), that no net income would be used for transfers to the FSO or HIPC, and that non-borrowing countries would make additional contributions. The cost of participating in HIPC will be shared by all IADB members, with Latin American countries contributing $150 million, the UDS$ 200 million, and the non-regional members another $200 million. As part of the negotiations, Brazil obtained an agreement that one of its nationals would occupy the number three position in the IDB management structure, and in exchange it agreed to convert a higher proportion of its FSO holdings in local currency than the other Latin American countries.

These are extracts from the agreement reached at the Seventy-eight Meeting of the Committee of the Board of Directors of the IADB:

- Brazil makes available 80 percent (US$ 718 million) of local currency. All other countries except for D-2 countries [the poorest] make available 65 percent (US$1,435 million) of local currency.
- Taking into account availability, types and sources of resources, and the agreed lending program, conversion flows will be established by the Board of Executive Directors in consultation with Management.
- Total D-2 country resources will be converted after the year 2009. In the exceptional event that the D-2 countries are not able to fulfill this commitment, non-borrowing countries will undertake to find a solution to the problem without further commitment by borrowing countries.
- Each non-borrowing country will make its best efforts to accelerate payment of its flow of FSO convertible-currency resources under the Eighth General Increase in Resources.
- The agreement implies acceptance by the Board of Governors that the net income of the Bank's Ordinary Capital, beyond that provided in the Eighth Replenishment Agreement, will not be allocated to the FSO or HIPC.

The two main sources of income for MDBs are loan portfolios and the management of liquid assets, (although some MDBs have also generated small amounts of income from charges for non-lending services to its members and other clients). Income from loans can be raised in only two ways. First, the volume of lending may be increased, but this may lead to pressures to lend more than would be strictly appropriate. Secondly, loan charges many be increased, which may make the MDBs noncompetitive with capital markets for countries with access to them - especially when factoring in transaction costs to borrowers (delays, conditionality). Without adequate safeguards, any of these options may lead to a deterioration of the loan portfolio, primarily because loans to less creditworthy borrowers may represent a higher proportion of loan assets and because countries that would be better credit risks may elect not to borrow from MDBs.

Income from the management of liquid assets can be raised by increasing the resources at the disposal of the MDB for short-term investment in capital markets, and by assuming higher market risks in the expectation of obtaining higher returns. However, this source of income is rather volatile and subject to capital market swings, which makes it unreliable. It cannot be counted upon at time of international financial crisis, which is presumably when it would be most needed.

The option of increasing loan charges to augment operating and net income has been adopted by some MDBs. This is closely related to the question of graduation of borrowing countries and has problematic aspects, not least of which is that there is a limit to such increases if the MDBs wish to remain relevant to all their shareholders. For example, governments in high and middle income developing countries with access to private sources of finance may prefer borrowing in capital markets, thus reducing the demand for MDB loans - which in turn would have a negative impact on the quality of MDB portfolios.

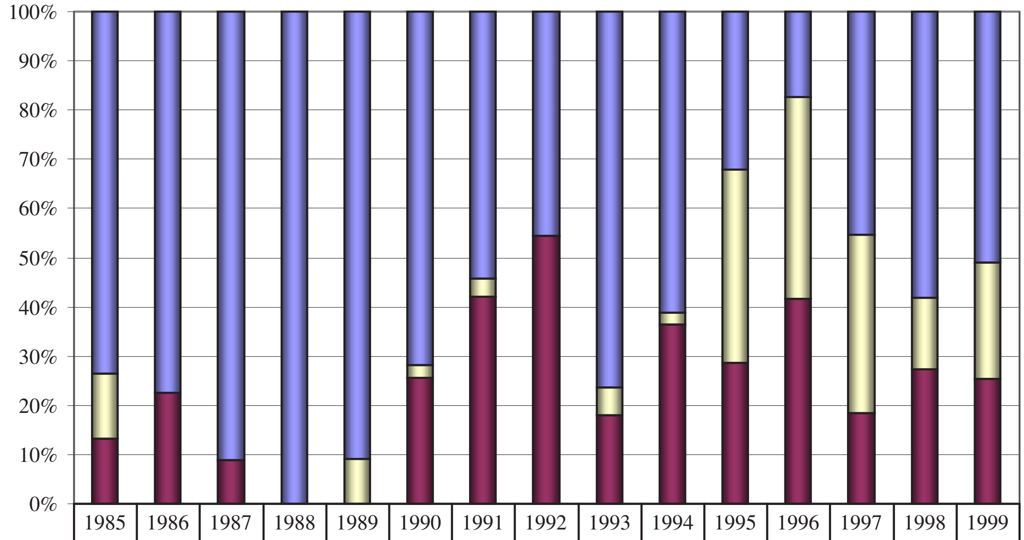
Each MDB has taken a different approach to the management of net income. These approaches are influenced by differences in power relations and interests among major shareholders, which have pressed for different allocations of net income to reserves, transfers to concessional lending windows, the provision of grants and reductions in loan charges. The World Bank has had a long tradition of transferring a portion of net income to IDA and to grants, although allocation to reserves has been the main use during the last 15 years. The African Development Bank has allocated between 75 and 80 percent of its net income to general reserves during the last four years, as well as smaller amounts to finance HIPC, to contribute to the African Development Fund and to build a special reserve. (Figures 17 and 18).

The Asian Development Bank revised its net income allocation policy in light of the impact of the Asian financial crisis. After having contributed about US $730 million to the Asian Development Fund and the Technical Assistance Fund from net income derived from its Ordinary Capital Resources, the AsDB Board decided to allocate total net income to build up reserves, so as to improve its financial indicators and its reserves to loan ratio (risk-bearing capital ratio). Following a surge in lending from US $16.4 billion in 1996 to US$ 28.7 billion in 1999, the reserves to loan ratio fell from 40.6 percent to about 26 percent in 1999, and was projected to be in the range of 20.4 to 23 percent in 2000-2005. This would be below the minimum 25 percent established by the ADB Board. The result is that practically all AsDB net income over the next few years will be used to bolster reserves; technical assistance grants and contributions to the concessional lending window of the AsDB will not be made. As the cost of HIPC to the Asian Bank is estimated in the range of just US$100 million and, if it materializes, will be covered by Japan, debt forgiveness does not represent a problem for this institution.

4.6 *The Highly Indebted Poor Countries (HIPC) initiative and its impact on the MDBs*

The HIPC initiative is intended by the international community to provide comprehensive debt relief to allow poor countries with good policies to escape form unsustainable debt burdens. Unsustainable debt, conventionally defined as a ratio of debt service to exports exceeding 25 percent, has increasingly been recognized as a constraint on the ability of poor countries to pursue sustainable human development. The original HIPC initiative was launched in the Fall of 1996, and an enhanced version was approved three years later.

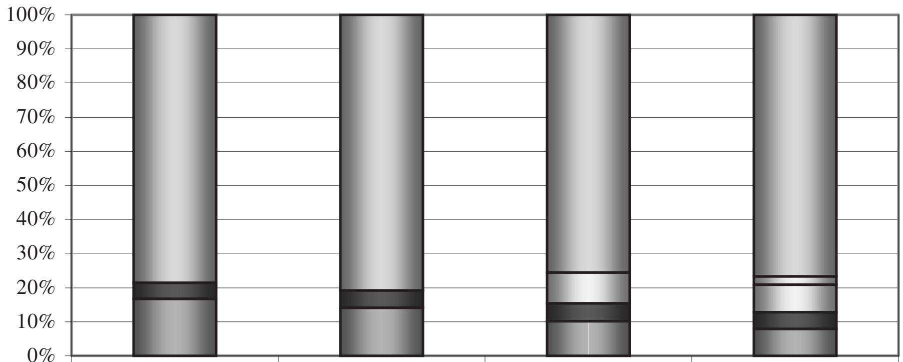
FIGURE 17
International Bank for Reconstruction and Development: Uses of net income
(US$ millions)



	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Allocation to reserves	837	963	1013	1004	994	750	450	250	1980	505	280	250	500	750	700
Transfers by way of grants	150	0	0	0	100	29	30	0	150	20	340	590	400	190	325
Transfers to IDA	150	281	100	0	0	267	350	300	465	300	250	600	204	352	348
Total net income	1137	1244	1113	1004	1094	1046	830	550	2595	825	870	1440	1104	1292	1373

Source: Net income allocation IBRD, World Bank Group.

FIGURE 18
African Development Bank: Uses of net income
(US$ millions)



	1996	1997	1998	1999 *
Transfer to General Reserves	114.6	133.1	119.5	133.5
Allocation to Special Relief Fund	0.0	0.0	0.0	4.2
Allocation to ADF-VIII	0.0	0.0	14.1	14.1
Allocation to HIPC	7.0	8.4	8.4	8.4
Special Reserve	24.3	23.2	16.0	13.7
Total Net income	145.9	164.7	158.1	173.9

Source: African Development Bank.

The combined external debt of all HIPCs was some $200 billion at end 1998. Although nominally small when compared with the more than $2 trillion owed by developing countries overall, the debt of the HIPC countries amounts, on average, to more than four times their annual export earnings, and 120 percent of GNP of all HIPCs. Behind these figures are deep human dimensions in countries that are the poorest on earth. Of the 600 million people in HIPC countries, more than one-half live in absolute poverty, defined as living on less than one dollar per day. The average person in a HIPC lives some 13 years less than the overall average for developing countries, and 7 years less than in other low-income countries. Compared to other developing countries, many more infants die either at birth or before they reach the age of five than in other developing countries, and far fewer go to school. Unlike much of the rest of the developing world, the vast majority of people living in HIPCs have seen no improvement in their lives for more than two decades.

The enhanced HIPC program adopted in September 1999 provides debt relief that is 'broader, deeper, and faster' than the initial version. As a result, the pace of implementation of HIPC debt relief has accelerated and the announced intention is to put the program in place very quickly. However, even though efforts are being made to link debt relief with sustainable poverty reduction programs in recipient countries (which are supposed to be fully owned by them), serious doubts are emerging about the quality and sustainability of the post-HIPC growth and about possible implications for development efforts. Figure 19 presents the process that the HIPC initiative is following.

The enhanced initiative has more than doubled the cost of the initial HIPC Initiative, and is now estimated at US $28.2 billion in 1999 net present value terms, about 40 percent of which relates to multilateral creditors (Table 13). The estimated cost of HIPC to the World Bank (IBRD and IDA) is US $6.3 billion in 1999 net present value terms. The fact that multilateral creditors account for such a high share of debt to be forgiven cannot fail but call into question the wisdom of past lending policies. It also calls into question the overall stewardship of MDBs by its shareholders, particularly its large non-borrowing members. It also raises questions about their ability and legitimacy of MDBs in the provision of policy advice and technical assistance.

The HIPC initiative has important financial implications for some MDBs, particularly for IDA (cost: US $5.7 billion) and for the African Development Bank (cost: US$ 2.2 billion), as well as for some subregional development banks such as the Central American Bank for Economic Integration (cost: US$ 390 million) and the Arab Bank for Economic Development in Africa (cost: US$ 180 million). Removing the burden of excessive debt is crucial for the development of the poorest countries, and few doubt that the initiative is most welcome and timely. However, there are a number of issues that merit attention, particularly for countries that depend heavily on concessional resources.

Whereas debt reduction can be achieved at the stroke of a pen, making use of the opportunities they create for economic and social development requires time, financial resources and the capacity to design and implement development programs. Industrialized countries, possibly under pressure from NGOs, are demanding faster implementation than may be appropriate to ensure success in terms of sustainable poverty reduction. Consultation between creditors and country ownership of strategies enshrined in the Poverty Reduction Strategy Papers (PRSPs) may also be a casualty of hasty implementation. A June 2000 report prepared by the US General Accounting Office (GAO) for Congress stresses this problem, pointing out that World Bank and IMF staff estimate that most HIPC countries should be able to prepare a poverty reduction strategy within two years but that Uganda, the country considered at the forefront of these efforts, had been working on such a strategy for five years.[36]

FIGURE 19

HIPC Debt initiative

First Stage

Country established three-year track record of good performance and develops together with civil society a Poverty Reduction Strategy Paper (PRSP); in early cases, an interim PRSP may be sufficient to reach the decision point.

• **Paris Club provides flow rescheduling as per current Naples terms, i.e. rescheduling of debt service on eligible debt falling due during the three-year consolidation period (up to 67 percent reduction on eligible maturities on a net present value basis).**
• Other bilateral and commercial creditors provide at least comparable treatment.

• **Multilateral institutions continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.**

EITHER

Paris Club stock-of- debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors **is adequate** for the country to reach sustainability by the decision point.

====> Exit

(Country is not eligible for HIPC assistance)

OR

Paris Club stock-of-debt operation under Naples terms and comparable treatment by other bilateral and commercial creditors **is not sufficient** for the country to reach sustainability by the decision point.

====> Decision Point

(World Bank and IMF Boards determine eligibility)

All creditors (multilateral, bilateral, and commercial) commit debt relief to be delivered at the floating completion point. The amount of assistance depends on the need to bring the debt to a sustainable level at the decision point. This is calculated based on latest available data at the decision point.

Second Stage

Country establishes a second track record by implementing the policies determined at the decision point (which are triggers to reaching the floating completion point) and linked to the (interim) PRSP.

• World Bank and IMF provide interim assistance.
• Other multilateral and bilateral creditors and donors provide interim debt relief at their discretion.
• All creditors continue to provide support within the framework of a comprehensive poverty reduction strategy designed by governments, with broad participation of civil society and donor community.

'Floating' Completion Point

• Timing of completion point is tied to the implementation of policies determined at the decision point.
• All creditors provide the assistance determined at the decision point; interim debt relief provided between decision and completion points counts towards this assistance:
- Paris Club goes beyond Naples terms to provide more concessional debt reduction of up to 90 percent in NPV terms (and if needed even higher) on eligible debt so as to achieve an exit from unsustainable debt.
- Other bilateral and commercial creditors provide at least comparable treatment on stock of debt.
- Multilateral institutions take additional measures, as may be needed, for the country's debt to be reduced to a sustainable level, each choosing from a menu of options, and ensuring broad and equitable participation by all creditors involved.

Source: From HIPC website, http://www.worldbank.org/hipc

36 United States General Accounting Office (GAO), *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, Washington DC, June 2000.

TABLE 13
HIPC Initiative: Estimates of Potential Costs by Creditor
(US$ billion in 1999 Net Present Value terms)

	Potential Total Costs[1]
TOTAL COST	**28.2**
Bilateral and commercial creditors	**14.1**
IMF	**2.3**
Multilateral Development Bank (MDB) creditors	**11.8**
World Bank Group	6.3
International Development Agency (IDA)	5.7
International Bank for Reconstruction and Development (IBRD)	0.6
Regional Development Banks	4.04
Inter-American Development Bank (IDB)	1.1
African Development Bank / African Development Fund (AfDB/AfDF)	2.2
Asian Development Bank (AsDB)	0.10
European Union / European Investment Bank (EU/EIB)	0.64
Sub-regional Development Banks	0.83
Central American Bank for Economic Integration (CABEI)	0.39
Caribbean Development Bank (CDB)	0.02
Corporación Andina de Fomento (CAF)	0.08
Nordic Investment Bank (NIB)	0.003
Islamic Development Bank (IsDB)	0.11
East African Development Bank (EADB)	0.01
Arab Bank for Economic Development in Africa (BADEA)	0.18
West African Development Bank (BOAD)	0.04
Other Funds which operate in a similar way as MDBs	0.45
Nordic Development Fund (NIF)	0.01
International Fund for Agricultural and Rural Development (IFAD)	0.23
Arab Fund for Economic and Social Development (AFESD)	0.06
OPEC Fund	0.15
Other multilateral[2]	0.17

Source: Modifications to the HIPC Initiative IDA/SecM99-475 and EBS/99/138, July 26, 1999; creditor and staff estimates.

Notes:
1 Estimates for 32 countries excluding Ghana, which not requested HIPC Initiative assistance, and Liberia, Somalia and Sudan.
2 Other multilateral: Caricom Multilateral Clearing Facility, Banque Centrale des Etats d'Afrique de L'Ouest, Banque des Etats de L'Afrique Central, Fund for the Financial Development of the River Plate Basin, Arab Monetary Fund, Fund for Compensation and Development Economic Community of West African States, Fondo Centroamericano de Estabilización Monetaria, Conseil de Léntente, Eastern and Souther African Trade and Development Bank.

A second issue that merits attention lies in the danger that HIPC will divert attention away from the fundamentals of strengthening countries' balance of payments and creditworthiness situations. As we have seen, assistance in these areas has been one of the principal roles played by the MDBs. It is well known but often overlooked that for many years HIPC countries received external finance on exceptionally soft average terms. Those same countries have long been in receipt of large flows of grant finance, mostly from bilateral sources. The result is that, over a very extended period the average financial terms of these combined sources of capital have been very low. This, however, failed to prevent very serious debt servicing problems from developing due to a combination of low domestic savings and the low productivity of new investment. The concern has been expressed, therefore, that the link between HIPC and PRSPs may tend to focus conditionality more on immediate measures to deal with poverty and less on the macroeconomic and structural weaknesses on which lasting poverty reduction depends.[37] The obvious answer to this concern is that HIPC will be structured so that underlying economic 'fundamentals' and direct poverty reduction measures are tacked simultaneously. It remains to be seen, however, whether this amounts to an overloading of objectives onto the debt relief instrument. There are also possible longer term implications in a reduced role for MDBs in assigning attention to balance of payments and macroeconomic management issues.

A further possible implication of HIPC relates to the future of MDB concessional lending. HIPC countries receive loans from the concessional windows of the MDBs, which are replenished periodically with contributions from donor countries and transfers from the net income of MDBs. Over time, the 'reflows' or repayments of these loans have expanded the resources available for lending through these soft windows. As an example, the IDA-12 replenishment of approximately $20 billion was covered by $11 billion in pledges by donor countries and $9 billion by IDA reflows and transfers from World Bank's net income. In the current rather constrained environment for development assistance, there have been discussions on whether and when IDA would become self sustaining, requiring no further pledges from donors, or at least reducing their contributions without cutting down the level of total resources provided to the poorest countries. The assignment on a large scale of IDA reflows to HIPC would bear directly on such possibilities.

The preparation of a Poverty Reduction Strategy Paper (PRSP) is a prerequisite for obtaining debt relief from bilateral and multilateral creditors. PRSPs are required to outline poverty reduction goals and plans for attaining them. Countries must then demonstrate progress towards these goals before funds are released (Box 5). In principle, PRSPs should provide a framework for all donors involved in a country to work together. In practice, however, many interpret them as completely dominated by the World Bank and the IMF by other MDBs, some bilateral agencies and some potential debt relief recipients. There is great time pressure on both MDBs and on the HIPCs. Countries want to benefit from debt relief as soon as possible, while the financial institutions want to be seen as taking swift action. Of the 40 countries currently eligible for HIPC relief, about 25 hope to have PRSPs in place by the end of 2000.

In short, PRSPs need to be carefully designed with significant involvement of all segments of society in HIPC countries, and should also be analytically sound and practical. This takes time and a great deal of effort, and it is not clear that this is will happen with the current implementation schedule. As a consequence, PRSPs may end up being the Achilles heel of the HIPC process.

---

[37] See Killick, Tony*, HIPC II and Conditionality: Business as Before or a New Beginning,?* Paper commissioned by Commonwealth Secretariat for Policy Workshop on Debt, HIPC and Poverty Reduction, 17-18 July, 2000.

BOX 5

Some key features of the Poverty Reduction Strategy Papers

Poverty Reduction Strategy Papers are intended to ensure that debt relief provided under the enhanced Highly Indebted Poor Countries (HIPC) initiative and concessional loans from the international financial institutions help to reduce poverty in the poorest, most indebted developing countries.

PRSP should identify:

- Poor populations and the causes of poverty;
- A macro-economic framework for the country;
- Assessments of the distributional impact of adjustment reforms;
- Public expenditures required for poverty reduction programs, including health and education, rural infrastructure, rural credit programs;
- Strategies for overcoming poverty, e.g. social sector programs, actions to promote growth and capacity building, rural development, local infrastructure, job creation by the private sector, increasing participation and good governance;
- Outcome indicators to be set and monitored through participation processes, so as to chart progress towards International Development Goals for 2015 (e.g. poverty reduction; child, infant mortality and maternal mortality reduction; attainment of universal primary education).

The intention is that PRSPs should be:

- Country-driven: with governments leading the process and broad-based participation in the adoption and monitoring of the resulting strategy;
- Results-oriented: identifying desired outcomes and planning the way towards them;
- Comprehensive: taking account of the multidimensional nature of poverty;
- Long-term in approach: recognizing the depth and complexity of some of the changes needed;
- Based on partnership: between governments and other actors in civil society, the private sector and the donor community.

The process of drawing up and implementing a Poverty Reduction Strategy will vary from country to country and will take place against the backdrop of national planning and electoral cycles. To identify opportunities for partnership it is helpful to think of a process as having five basic stages, as sketched in the following:

Stage 1 Analytical and diagnostic work	Research to deepen the understanding of poverty and reflect the diversity of experiences (e.g. according to gender, age, ethnic or religious groups).
Stage 2 Formulation of the strategy	Analysis of the poverty impact of a range of public expenditure options. Identification of public actions which will have most impact on poverty.
Stage 3 Approval:	Approval at country level, then formal approval by the World Bank and IMF Boards—at which point debt relief and/or concessional loans become available.
Stage 4 Implementation	Agreeing roles and responsibilities with government and service providers at local level. Monitoring implementation. Feedback to revise the Strategy and enhance its future effectiveness.
Stage 5 Impact assessment	Retrospective evaluation of the poverty Reduction Strategy to derive lessons for subsequent versions

It remains to be seen to what extent the new PRSP approach can really offer a meaningful part to the poor. Providing poor people with the chance to contribute to PRSPs, directly or via their civil society representatives, is an important start. But it is only the first step in making development strategies truly responsive to the needs of the poor.

Source: IDS, 2000, ‘Poverty Reduction Strategies: A part for the Poor?’ *IDS Policy Briefing* Issue 13: April 2000.

5. TOWARDS A FRAMEWORK FOR STRATEGIC CHOICES

Building on the preceding analysis, this section will consider five aspects of the operations of the MDBs in an attempt to articulate a framework for strategic choices for these institutions. These are: the need to maintain relevance to their stakeholders, and to their shareholders in particular; the product line of the MDBs; the division of labor and coordination of their activities at the field level; their capital adequacy and the impact of the HIPC initiative; and some management and administration issues. Each of these can be considered as a strategic direction requiring shareholders to make choices. This discussion will be preceded by some remarks on the development role that MDBs could play in different contexts.

5.1 *The future evolution of the international context and the roles of MDBs*

Two extreme situations (scenarios) can be visualized as a backdrop to examine the roles that the MDB family of institutions could play at the intersection of the development and international finance systems during the next decade. The first configures an exceedingly negative situation for the factors and variables that affect the world economy and the prospects for developing countries, while the second visualizes a positive situation for all of these. There is a continuum of possibilities between these two extremes, although the contrast highlights the impact of contextual changes on MDB operations.

5.1.1 *A negative scenario*

This scenario envisages a significant slowdown in world economic growth, associated with major problems in leading economies and increased volatility in international financial markets, which steer the world economy perilously close to global deflation. Illegal migration, environmental degradation, natural resource disputes, volatility in oil and other commodity prices, religious and ethnic strife, and the spread of illegal activities all combine with economic crises to create an unfavorable context for development efforts.

Inflation heats up in the US economy and the trade deficit becomes unsustainable, leading to adjustments in interest rates, equity valuations and exchange rates; the 'exuberant irrationality' of investors prevents a soft landing of the US economy and the transition towards a 'new economy' is aborted. These developments spill over to Europe and Japan, leading to reductions in consumption growth and a sharp investment slowdown. Political frictions, partly linked to the expansion of the European Union and partly from trade disputes with the US (e.g. over genetically modified organisms), amplify economic difficulties in Europe and steer the continent into a low growth path. Japan's incipient recovery is stalled and fiscal and financial sector problems, coupled to demographic shifts and divergent generational expectations, keep its economy mired in recession.

Major Asian economies experience reversals in their recovery processes, significant problems persist in countries such as Indonesia and Malaysia, and the entrance of China into the World Trade Organization disrupts investment and trade flows (e.g. China increases its share of direct foreign investment and its exports displace those of other Asian economies). Political unrest and social problems, coupled to the difficulties of the US economy, keep Latin America well below its growth potential. Political turmoil and the volatility of oil prices create unstable conditions for Middle East countries; the transition to an orderly market economy is delayed in Russia and other East European and Central Asian countries; and Sub-Saharan Africa remains increasingly marginalized, with South Africa failing to become the regional growth engine that was envisaged in the early 1990s.

In such a negative context, efforts to half world poverty by 2015 are derailed. There are no significant advances to create a new international financial architecture, and piecemeal adjustments and lowest common denominator responses prevail when dealing with financial and economic imbalances and asymmetries. Direct foreign investment retreats to safe havens and to traditional areas and sectors, and there is a flight to quality and safety in portfolio investments; as a result, private flows to developing countries diminish and their concentration becomes even more pronounced. The declining trend in Official Development Assistance continues, as most donor countries experience economic difficulties and focus on domestic needs and problems. Experimentation with new forms of development financing is halted, and the growth of private philanthropy is suddenly reversed, partly because the decline in the value of the stock portfolios of private foundations. Total flows to developing countries diminish, fractures in the global order (e.g. 'digital, divide') become more profound, and uncertainty and disarray prevail in the international development community.

5.1.2 *A positive scenario*

This scenario envisages that world economic growth stays on course, with just some minor fluctuations around a high-growth trend. Global trade imbalances and commodity prices fluctuations are gradually and smoothly adjusted, and a combination of national policies and international agreements succeed in reducing the volatility of international financial markets. An awareness of the economic implications of demographic imbalances leads to more enlightened immigration policies in the world's major economies, and international agreements to protect the environment are put into practice. More enlightened domestic leadership, backed with international support, defuses tensions and creates new opportunities for peaceful development in parts of the world riddled with ethnic and religious conflicts.

The US succeeds in managing inflationary pressures and in gradually bringing down its trade deficit, which maintains interest rates, the stock market and exchange rates within reasonable limits that allow a soft landing of the US economy. The benefits of the new information economy lead to steady increases in productivity and spill into the more traditional sectors. Europe manages to sustain its economic recovery, to resolve its trade disputes with the US and to expand eastward without major disruption. Japan accelerates its economic growth, succeeds in restructuring its financial system and in overcoming fiscal constraints, and begins to adjust to its new demographic structure while building bridges between generations.

The recovery of the Asian economies remains on track and the painful adjustments of the late 1990s (e.g. financial sector restructuring) yield the benefits of a return to customary high growth rates. China manages carefully its incorporation into the WTO, avoiding flooding their trade partners with exports, while absorbing direct foreign investment at a judicious pace and in a selective manner. Latin American countries overcome their most serious political problems and are able to forestall social unrest, which unleashes growth potential and allows sustained economic recovery. Peace agreements and political transitions create an unusually favorable environment for economic growth and social advance in the Middle East; and a combination of institutional reforms and sensible economic policies accelerate the transition to a modern market economy in Russia and other countries in Central Asia and Eastern Europe. Sub-Saharan Africa begins a slow but steady process of economic recovery, helped by the easing of political tensions in various parts of the region and by the success of South Africa in addressing major social problems while maintaining sensible economic policies.

Efforts to half world poverty by 2015 meet with considerable success. As successive milestones are reached, commitments to meet this goal are periodically and effectively renewed by the international community. A new international financial architecture has begun to emerge, primarily through a series of interlocked agreements between key players in different segments of the international financial system, and developing country interests are largely taken into account in these agreements. Direct foreign investment moves into new areas and sectors, and its concentration diminishes in an appreciable manner. Improvements in the economy and more enlightened political leadership manage not only to maintain the levels of ODA, but to increase it and to incorporate new donors. New forms of development financing emerge and are implemented (e.g. the Clean Development Mechanism), private foundations have stepped up their involvement in developing countries, and a few limited-scale international tax experiments are launched to finance the provision of regional and global public goods. Some of the fractures in the global order, such as the digital divide and inequalities in the access to vaccines and basic health care, have began to be bridged through international initiatives.

5.1.3 *Some implications for the MDBs*

The roles MDBs would play in each scenario are quite different (Table 14). For example, in the positive scenario, the rationale for MDB *financial resource mobilization* role would be less compelling. Activities would center around the needs of the poorer countries and on enhancing private flows. By contrast, in the negative scenario the financial mobilization role would acquire greater importance and would involve all categories of developing countries, as the MDBs assume fully their countercyclical lending role to compensate for shortfalls in private and bilateral official flows. The implications for lending levels, capital adequacy, net transfers and the uses of operating and net income would be quite different in each scenario.

In the positive scenario, *capacity building, institutional development and knowledge brokering* role would focus on helping developing countries to profit from the opportunities offered by an expanding and stable world economy, particularly by creating the domestic conditions to make effective use of international trade and finance. In the negative scenario the MDBs would focus on helping developing countries to weather an adverse environment, strengthening safety nets for the poor, and helping to consolidate and maintain hard won gains in the social sectors. They would also foster regional cooperation between developing countries to make more effective use of their limited resources.

The MDB's role in the *provision of regional and global public goods* would also differ in the two scenarios. In the positive one they would focus on expanding the provision of such goods, primarily through forging strategic alliances with regional and international organizations, bilateral aid agencies and private foundations. In the negative scenario, the emphasis would be on support to the measures and initiatives of other international institutions attempting to avoid or minimize public 'bads'. This means stepping up involvement in conflict prevention, fighting against the spread of diseases and reducing environmental degradation. Also, the positive scenario would allow exploring and setting up new forms of financing for public goods, a task that would be practically impossible in a negative scenario.

What is most important to note is in these two extreme scenarios (and on any intermediate one), *there is an important role for the MDBs.* They are clearly needed under both. While there are several other institutions at the intersection between the international development system and the international financial system, none can furnish the combination of products and services that the MDBs are capable of providing under such a broad range of international circumstances.

TABLE 14

MDB roles in a positive and a negative international context for development

	International context	
MDB Function	***Positive scenario***	***Negative scenario***
Financial resource mobilization	Less important for middle and high-income countries; focus on enhancing private flows and on providing emergency loans; emphasis on concessional resource mobilization for poor countries.	More important for all types of borrowing shareholders; countercyclical lending for both regular and concessional windows; emphasis on maintaining investment levels to reduce poverty.
Capacity building, institutional development and knowledge brokering	Focus on taking advantage of expanding opportunities in trade, financing; strengthening domestic financial and tax systems; building science and technology capacities.	Focus on maintaining social sector gains; cushioning impact of crisis (safety nets); improving public sector management; promoting regional cooperation.
Providing regional and global public goods	Focus on creating and expanding the provision of public goods; establishing predictable and assured forms of financing; promoting strategic alliances between stakeholders.	Limited role, largely focused on maintaining minimum levels of essential public goods, and on avoiding public 'bads' (conflict prevention, basic health).

5.2 *Maintaining the relevance of the MDBs*

As already emphasized, MDBs are challenged today to maintain their relevance to a growing diversity of stakeholders, and to their shareholders in particular. Their continued existence and growth depends on keeping, in the first place, a strong political support from all their shareholders (and not only from the most powerful ones). In turn, this implies having the capacity to respond adequately to the continuously changing demands of an increasingly diverse set of shareholders. Second, after addressing the concerns of shareholders, MDBs should respond to the demands of other stakeholders, including international organizations, bilateral development agencies, financial markets, private firms and corporations, academic and policy-making institutions, non-governmental organizations and MDB staff (See Table 10 for a list of stakeholders).

Maintaining relevance requires strengthening the commitment of shareholders to the MDB model and to the MDB family of institutions as a whole, recognizing them as an effective means to promote international development. MDBs perform a rather unique combination of functions: financial resource mobilization; capacity building, institutional development and knowledge brokering; and provision of regional and global public goods. This triple role is an essential feature of the MDB model.

5.2.1 *Visualizing the MDBs as a system*

Each multilateral development bank has a different set of constituencies to which it is accountable, and has to develop a strategy to respond to what has become a rather complex set of disparate and conflicting demands. However, what may be described as *the different 'personalities' of the MDBs should not prevent visualizing them in an integral manner, as a set of organizations that share common characteristics, play similar roles and conform broadly to the same institutional model*. Considered as a whole, they constitute a fifty year-old institutional innovation to channel financial resources and knowledge from richer to poorer countries, while at the same time providing a range of complementary services to its various constituencies.

If stakeholders are to adopt a systemic approach to the MDBs, a major shift in perspective will be required. This would move beyond the current practice of focussing on the World Bank, and occasionally on one or another regional development bank, and would try to establish a broad strategic framework aimed at making the entire system function better. Such an approach would necessarily include the subregional MDBs and other funds that operate as MDBs. Viewed in this perspective, the challenge is to transform more or less disparate institutions into a more efficient network and eventually into an effective system. This has important implications for the division of labor between MDBs and for the coordination of their activities in their borrowing countries. Yet, this should not entail the elimination of unique qualities, experiences and comparative advantages. The World Bank and a smaller subregional bank should not be expected to function in identical ways. Differences and distinct personalities should also be respected and even encouraged, and the aim should be to achieve a balance between unity and diversity in the system.

Far from functioning as an integrated system, however, it must be said that the MDBs currently behave more like a dysfunctional family, primarily in the field. Relations between the World Bank and the regional development banks are strained in several regions and in many countries, while most subregional MDBs have little interaction with the World Bank. Differences in management styles, extent of field presence, relations with borrowers, technical competence, knowledge of the region and countries, among others, combine to create sources of tension that could and should be reduced by taking a more systemic approach to the operations of MDBs.

The discussion of net transfers in the preceding section illustrates the value-added that derives from adopting the integrative perspective. For example, from 1990 to 1998 the Andean Finance Corporation (CAF) played a larger role than the IADB and the World Bank in net resource transfers to the Andean region countries. CAF had positive transfers in all those years, IADB in four of them and the World Bank in just one (Figure 16). Also, over the last three decades, regional development banks have, by and large, maintained larger positive transfers in the region they operate in comparison to the World Bank (Figures 14 and 15).

Nevertheless, although some MDBs may be in a negative net transfer situation with specific countries and in some regions, the system as a whole is in a positive position. This is not surprising, for some banks hold less mature portfolios that others.

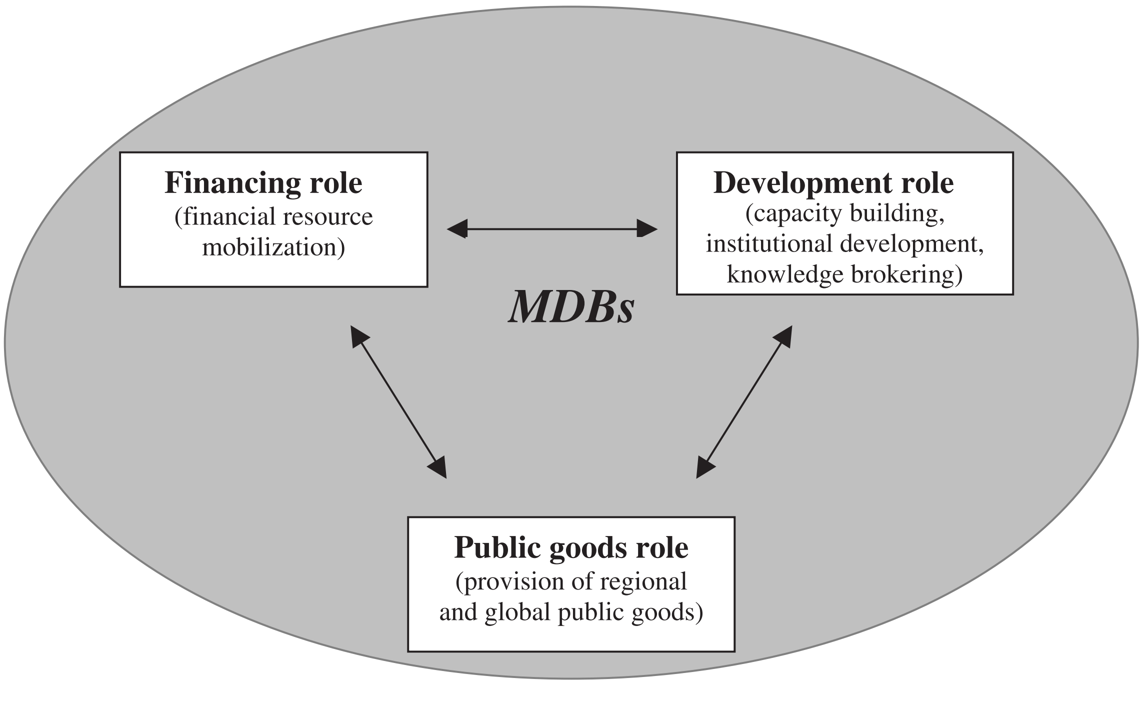
Thus, the interests of international development would be well served by a *systemic approach on the part of shareholders, including* a *strengthening of commitment to the MDB institutional model.* Marshalling support for individual MDBs should build on the foundations of such commitment and progressively advance towards an effective system of MDBs.

5.2.2 *The triple role of the MDBs*

An essential feature of the MDB model is the delicate balance they must preserve between their three main functions: (a) financial resource mobilization; (b) capacity building, institutional development and knowledge brokering; and (c) providing regional and global public goods (Figure 19). Not each and every MDB should be involved in these functions to the same extent and degree in the various countries and sectors, but the MDBs as a whole should cover all of them.

As indicated in Section 2.3, there has always been a fundamental tension between the financing and development roles of the MDBs. This has been exacerbated by the relatively recent addition of a public goods function. Tensions between the financing role, on one hand, and the development and public goods roles, on the other, are at their highest level in years in some MDBs (e.g., the Asian Development Bank, the Central American Bank for Economic Integration and, to a lesser extent the World Bank). The combined impact of financial crisis in Asia, Russia and Latin American, of a generalized increase in the volatility of financial markets, and of new demands on the MDBs are forcing tradeoffs between pursuing one or another function at the expense of the others.

FIGURE 20
The triple role of the Multilateral Development Banks



The growing importance of the public goods role played by the MDBs has created a new set of tensions. It has been argued that development assistance may increasingly take the form of public goods, some of which may be provided directly by donor countries and others by regional organizations and multilateral institutions.[38] Unless overall funding levels are increased, this leads to the hypothesis that, as increasing percentages of ODA are assigned to international public goods, there will be a high opportunity cost to other forms of development assistance, particularly for capacity building and institutional development. Also, the current trend in the provision of public goods is to use grant financing and this could prove quite problematic for MDBs by creating further competing pressures on the use of net income to bolster reserves and strengthen the financial position of the MDBs.

Financial resource mobilization, however, preserves the financial integrity of the MDBs and this is considered as the '*primus inter pares*' of these three functions. Providing loans to borrowing member countries is an essential condition for the existence of an MDB, and neither of their other two functions could be performed without preserving their capacity to make loans.

5.3 *The product line of the MDBs*

MDBs need to expand and adjust the range of products and services to adequately perform their three functions, and, again, to maintain shareholder and other stakeholder support.

5.3.1 *Financial resource mobilization*

There have been significant shifts in the structure of lending operations during the last two decades, which have important implication for future changes in and additions to the product lines of MDBs.

<u>Financial products and services</u>. For over four decades, various combinations of project, program and sector *investment loans* have been the main products of the MDBs. We have seen, however, that recent trends in the World Bank and the regional development banks are away from investment loans in traditional sectors, such as transport and energy, the expectation being that private investment (and in some cases, sub-regional development banks) will gradually take up this role.

In the World Bank, a growing proportion of loans are in the form of fast disbursing, policy-based *adjustment lending* for balance of payments support. At the same time, the larger MDBs are assigning new emphasis on *lending for the social sectors* (e.g. education, health, population and social safety nets) and for *institutional development* in new fields such as judiciary reform, privatization of State-owned enterprises and strengthening of public the public sector. The time required to develop social sector and institutional development projects is usually longer than that involved in the preparation of infrastructure and similar project loans. A different staff skill mix is required to develop and negotiate these loans, which also require that the borrowing country assume full ownership of the project or program. MDB staff members are often reluctant to engage in the type of time-consuming

[38] See: Ravi Kanbur, Todd Sandler and Kevin M. Morrison, *The future of development assistance: common pools and international public goods*, Washington DC, Overseas Development Council, Policy Essay No. 25, 1999, especially chapter 4.

and laborious interactions required by this type of operation, which increases administrative costs significantly. Nevertheless, the MDBs re under increasing pressures to emphasize these labor-intensive areas and to do so at a time when institutional administrative budgets are constrained.

In comparison to traditional investment projects in roads, irrigation or similar projects, *social sector operations involve a higher proportion of current expenditures* to ensure the sustainability of investments over time. Unless measures are taken to ensure the steady financing of current expenditures - which usually come out of public sector budgets or user charges - the expected returns to MDB loans in these areas will not materialize. The question that this raises is how MDBs can help to increase public revenues through financial and fiscal sector reforms. It also suggests the need to *explore new forms of assisting poor countries to cover recurrent expenditures*. For example, establishing special purpose endowment funds in developing countries, which could be financed with donor support, debt swaps, proceeds from privatization of state assets and possible budget allocations, is a possible approach to cover current expenditures for specific purposes. It has been followed, although on a small scale, to finance biodiversity conservation and other environmental programs. It could, in theory at least, be extended to other areas. However, if not used in a judicious manner, this approach could lead to the proliferation of small special purpose funds that bypass the regular public expenditure allocation process.

The financial crises of the 1990s (Mexico, East Asia, Russia, Brazil) showed that the MDBs can play an important role in assisting middle income countries that have either only partial access to private capital markets or that are suddenly cut from them for reasons beyond their control. The surge in MDB lending at the time of the Asian crisis helped several of the affected countries to cushion the impact of a sudden reversal of private financial flows, and was an expression of the countercyclical lending role of these institutions. However, such a role needs greater clarity and formality, perhaps by *developing new financial instruments for this purpose, which could be similar to an 'insurance policy'*[39]. For example, the World Bank and the regional development banks could engage in a continuous policy dialogue with potential middle income borrowers in order to ensure satisfactory progress in economic and social policies, which in turn would be a precondition for access to the insurance policy. This raises the question of what type of support, if any, MDBs could provide to countries that chose not to participate in such a scheme. It also raises the issue of pricing an insurance policy, both to ensure its attractiveness to clients and to safeguard the financial exposure of the MDBs.

The greater role that private financing is expected to play in developing countries opens opportunities for *expanding the range of products to enhance private flows and provide comfort to private investors, including new guarantee schemes*. An emphasis on private sector operations is also justified by the fact that, during the 1980s and 1990s, most MDBs encouraged the privatization of State-owned enterprises and public sector institutions. This led to a reduction of the role of the public sector in developing and transition economies, and also limited the scope for traditional MDB loans to public sector institutions. However, there emerged a need for MDBs to assist in establishing regulatory agencies, providing guarantees to investors in public service concessions, and in complementing and monitoring private sources of financing.

[39] See the note by Guillermo Perry, former Chief Economist for Latin America at the World Bank: 'The World Bank and Middle Income Countries: Is there a Future?', Washington, July 15,2000.

The MDBs, and in particular the World Bank and the regional development banks, should continue to *mobilize concessional finance for the poor countries* through their soft loan windows. This can only be expected to happen if the MDBs continue to demonstrate a value added to bilateral donor countries and a strong comparative advantage in development effectiveness. The larger MDBs have frequently been perceived as a service to donor countries that would otherwise channel funds to poor countries through their own bilateral agencies, thus incurring additional costs in project preparation, processing, implementation and supervision. The aim should be to increase that perception by demonstrating its validity.

Recently, there have been a number of suggestions for major modifications in the way multilateral institutions and bilateral assistance agencies provide concessional resources to low income countries. One example is the 'common pool' approach which would aim at ensuring ownership of development programs by recipient countries, while at the same time preserving the ability of donors to maintain their own views on supporting development efforts, and at minimizing the problems of coordination.[40] This approach would be based on a national strategy, debated and agreed to by the widest possible cross-section of society in the developing country. Donors and recipients would engage in dialogue throughout the strategy formulation process, but there would be no discussions on specific sums of money from specific donors for specific projects. This would be followed by the preparation of a comprehensive public expenditures program, stating a range of options conditioned by the total level of financing available. The main idea is that the government would manage all its resources, including funds provided by bilateral donors and multilateral agencies, under one budget and one set of procedures, thereby ensuring coordination and ownership. The total amount and the assistance strategy provided by each donor would be defined on the basis of an evaluation of the national development strategy. Donors would not tie specific funds to specific projects or policy reforms, and support would be provided to a common pool of resources in support of the national strategy and the budget.

Another approach envisages a two stage process, in which concessional financing would be provided first to build capacity and then to support investment programs. In the first stage, the MDBs would help in assessing development priorities and poverty reduction strategies, placing special emphasis on capacity building, strengthening institutions and improving governance. At the same time they would provide broad based budget support through IDA, the soft loan windows of the regional development banks and bilateral aid agencies. Public Expenditure Reviews, the PRSP process in HIPC countries and the comprehensive development framework (CDF) approach would be among the preferred instruments to define the level and type of support provided by the MDBs, bilateral donors and others. This first stage requires a rather intensive involvement of MDB staff, major efforts in knowledge brokering and the spread of best practices, and would also place emphasis on creating a stable public revenue base. The second stage would focus on a selected number of sectoral investment programs (instead of specific projects), would be more capital intensive and would require technical assistance in specific economic and social sectors. The recipient country and the MDBs would bear the primary responsibility for designing these sectoral investment and technical assistance programs, and bilateral donors would complement the concessional funds provided by the MDBs through co-financing and parallel financing schemes. Developing countries that have already built an institutional

[40] Ravi Kanbur, Todd Sandler and Kevin M. Morrison, *The future of development assistance: common pools and international public goods*, Washington DC, Overseas Development Council, Policy Essay No. 25, 1999, chapter 3, especially pages 42-44.

capacity to design, manage and monitor development programs could skip the first stage and proceed directly to the second.

A further modification in MDB assistance to resource mobilization has involved debt restructuring or, more broadly, *private and public sector debt reduction operations.* This has been an atypical feature of World Bank and IMF operations since the late 19980s with the launching of the Brady Plan and of the Debt and Debt Service Reduction facility at IDA. This route to resource mobilization is exceedingly complex and involves issues of 'moral hazard.' MDBs should continue to approach it with caution. More recently the involvement of all MDBs in debt reduction has been stepped up as part of the Highly Indebted Poor Countries (HIPC) initiative. MDBs can also mobilize financial resources for developing countries through *initiatives to promote exports and to stabilize commodity prices* (Box 2).

5.3.2 Graduation, types of borrowers and MDB product differentiation

Graduation from the regular lending windows of the MDBs has been a recurrent issue in discussions of the financing role of the MDBs, and is closely related to the range of products offered to borrowers. In view of the need to maintain relevance to all shareholders, *policies of formal graduation of middle and high-income borrowers are not logical for MDBs*. Policy dialogue, from which much could be learned to pass on to other borrowers, would be lost; private capital markets do not provide stable access to middle income countries at reasonable terms, and cannot be relied to provide continued access to capital, especially at times of international financial turmoil; and private investors appreciate the participation of MDBs in many types of operations, for they provide comfort and reduce their risks.

It makes more sense to *differentiate products aimed at specific segments of borrowers, pricing them according to their characteristics*. In this way countries would self-select for graduation, taking into account not only the price of the loan but also the transaction costs (delays, conditionality) and the additional benefits they derive from them (policy dialogue, attention by the MDB). Avoiding formal graduation policies for their regular loan windows could also help in maintaining a more diversified and healthy portfolio of loans, thus reducing vulnerability.

For example, it should be possible to distinguish four types of non-concessional borrowers. First, there are the middle income countries in the midst of complex policy reforms, which should receive continuous MDB support and assistance. Second, there are those countries in the process of consolidating major reform efforts, which should have access to more streamlined and less conditional forms of assistance based not on further reform but on sustained macro-stability and a sound public expenditure framework. Third, there are upper middle income countries interested in the provision of non-lending services for a fee and in keeping open the possibility of receiving financial support in difficult situations (possibly through an 'insurance policy' scheme similar to the one described earlier in this section). Finally, there are those emerging developing countries that may require emergency lending for relatively short periods in the case of a widespread financial crisis, but here the division of labor between the MDB (particularly of the World Bank) and the IMF needs to be clearly addressed.[41]

---

41 See the comments by Catherine Gwin in 'Financing the Multilateral System: Proceedings of a Seminar convened by the Swedish Ministry for Foreign Affairs', Stockholm, 31 August 2000.

Graduation from the soft loan windows of MDBs is a different matter, which could be accomplished by establishing income thresholds for different mixes of regular and soft loans, as some MDBs do at present.

5.3.3 *Capacity building, institutional development and knowledge brokering*

The development role of the MDB requires a combination of *technical assistance*, *policy advice*, *training programs*, *institution building*, *using the convening power of MDBs to foster dialogue and consensus*, and an emphasis on *brokering knowledge* (spread of best practice, dissemination of information). These activities are usually backed by loans, occasionally by grants and in a few instances are provided on a cost recovery basis. Most investment and sector loans include technical assistance and training components, which have been the traditional instruments of building capacity. However, some MDBs - most notably the World Bank and the Inter-American Development Bank - have developed small scale (US $5-10 million) 'innovation' and 'learning' loans, which are much more flexible, faster to process and execute, and which are used to finance pilot projects, and to build institutional capacity in priority sectors. Lessons learned through the use of this instrument should provide the basis for larger scale loan operations.

Attention has already been drawn to the importance of s*ocial sector and public sector reform loans* in capacity building and institutional development. Other important capacity issues in national development involve *private sector capabilities, the strength of public sector management*, and capabilities in *local policy analysis and program/project design.* Although MDBs are active in all these areas, loan operations for these purposes tend to be rather small. Grant funding is usually involved, most often provided by bilateral agencies and private foundations acting in concert with MDBs.

There has been a recent emphasis on *good governance* as a necessary condition for development, and MDBs have been tasked to help developing member countries improve public accountability and participation, combat corruption and strengthen democratic practices. This has been approached by MDBs - and particularly of the World Bank and the regional development banks - through training, support for research, organizing events to share information on best practices, disseminating information, fostering dialogue with civil society organizations and providing small grants to government agencies and non-governmental organizations. Some sub-regional development banks (for example, the Andean Finance Corporation) have been involved in these activities, although to a much more limited extent.

Despite the growing recognition of the importance of scientific research and technological innovation in the development process, much more could be done by the MDBs to *support the creation and consolidation of science and technology capabilities in developing countries*. The World Bank and regional MDBs have contributed significantly to agricultural research, both through loans and through grants channeled primarily by the Consultative Group for International Agricultural Research (CGIAR). However, with the exception of the Inter-American Development Bank, loans for technological innovation and scientific research projects have not accounted for a significant share of their portfolios. New initiatives have been proposed in the field of information technology to bridge the 'digital divide,' but apart from a modest grant facility established at the World Bank with private corporations and foundations support, very little concrete action has as yet occurred.

5.3.4 *Provision of regional and global public goods*

Public goods are commodities, services or resources whose benefits are available to everyone. Consumption by one individual does not detract from that of another. If the benefit of the public good is limited geographically, it is a local or national public good, but if benefits accrue across all or many countries it becomes a global or regional public good. In practice, most public goods relevant to development are not ‘pure’ but are ‘mixed’ public goods, in the sense that they provide individual, local or national benefits, but also have spillover effects that are important to other countries. The World Bank has provided the following working definition of global public goods: ‘commodities, resources, services - and also systems of rules or policy regimes with substantial cross-border externalities that are important for development and poverty reduction, and that can be produced in sufficient supply only through cooperation and collective action by developed and developing countries’.[42]

For some time and in a variety of ways, the MDBs have been involved in the provision of public goods. They provide *information about the international economic situation and the economic and social conditions in developing countries*, *conduct and publish research on development issues*, *use their convening power to coordinate development assistance*, and provide grants for a variety of purposes such as *disaster relief, agricultural research and training*.

Since becoming deeply involved in *environmental matters* during the late 1980s and 1990s, the public goods dimension of MDB operations has acquired a new importance. This became especially evident with the launching of the Global Environment Facility by the World Bank, the United Nations Development Program and the United Nations Environment Program. The environmental operations of MDBs have expanded considerably during the last decade, and now extend to the biodiversity conservation, reducing deforestation, management of water resources, preventing deforestation and desertification, among others.

Additional public goods functions were added to the MDB agenda during the 1990s. *Peace building and reconstruction* efforts became important after the demise of the Cold War, *interventions to forestall health epidemics* - and particularly the spread of AIDS/HIV in sub-Saharan Africa - were upgraded, and there have been discussions about the role that MDBs could play in avoiding ‘public bads’ (corruption, money laundering, human rights abuses). Confronted by the magnitude and implications of these new demands, MDBs are attempting to achieve clearer definition of their role in the provision of public goods. Box 6 summarizes the approach take by the World Bank in this regard.

Entering into the regional and global public goods arena raises questions of the *appropriate division of labor between the MDBs and other international and regional organizations*, in particular the United Nations agencies. Most of the public goods interventions of MDBs involve strategic alliances with United Nations specialized agencies and other bodies, regional organizations, private foundations, bilateral agencies and even private corporations.

42 Development Committee, *Poverty reduction and global public goods: Issues for the World Bank in supporting global collective action*, Document DC/2000-16, Washington DC, September 6, 2000, p.2.

The financing of regional and global public goods raises the thorny issue of who should pay for them. For the MDBs, there is a sub-question of whether it is appropriate to subsidize the provision of such goods through transfers from net income? This option implies that MDB borrowers finance them through higher loan charges and that non-borrowing shareholders contribute through higher levels of paid-in and callable capital. There are clear limits to the extent that this could be done and continued expansion by MDBs into provider of public goods cannot be financed indefinitely through transfers from net income. Many public goods, however, are in fact mixed rather than pure public goods, and this makes it possible to provide such goods, at least in part, through loans to countries that benefit directly from those goods. Examples of how public goods can be financed through sovereign loans can be found in existing support to several countries to fight the regional and global spread of communicable diseases such as AIDS/HIV and tuberculosis.

BOX 6

The World Bank and the provision of public goods

The World Bank has adopted four criteria to determine which public goods to provide: (i) there needs to be clear value added to its development mission; (ii) its actions should catalyze other resources and build collaborative partnerships at the country, regional and global level; (iii) public goods interventions should build on its comparative advantage (operational experience and instruments at the country level, ability to mobilize and manage large financial and knowledge resources); and (iv) there should be emerging consensus in the international community that global action is required.

These criteria have led to the identification of several main areas of work for the World Bank in this field. First, *facilitating orderly movement across borders of information, capital, trade and labor.* While other international institutions should develop rules and standards for this purpose, the Bank should ensure a proper hearing for the viewpoints of developing countries and assist in building the relevant capacity for developing countries to participate in negotiations to set global standards. Second, *ensuring broad inclusion in the benefits of globalization*, by devising better ways of bringing the interests of developing countries into the international finance and trade frameworks, and by assisting collective actions to deal with major social and human problems (transmission of diseases, spread of civil conflict). Third, *preserving and protecting environmental resources*, an area in which the World Bank has built substantive experience during the 1990s. Fourth, *creating and sharing knowledge*, particularly through research on development problems, the provision of information and dissemination activities, and also through initiatives to link developing countries to the information economy.

Within these areas the World Bank has further focussed its attention on issues such as promoting improved economic governance at the international level, fostering trade integration, fighting communicable diseases, protecting the global environmental commons and providing information and knowledge about the process of development.

Source: Development Committee, *Poverty reduction and global public goods: Issues for the World Bank in supporting global collective action*, Document DC/2000-16, Washington DC, September 6, 2000.

Costing the provision of regional and public goods is a difficult but necessary exercise to avoid the usual public goods problems (e.g. under-provision, free riding), and should involve the various stakeholders directly or indirectly affected by them. Ultimately, in order to achieve an appropriate burden sharing of the costs of providing such goods, some sort of automatic financing mechanism will be required (i.e. regional and global tax schemes). Although this appears to be anathema to some MDB shareholders at present, it is difficult to envisage the continued and effective provision of such public goods without access to predictable and assured sources of funding.

5.4 *Division of labor and coordination*

The division of labor between the MDBs and other development actors (including private sources of funding), as well as between the MDBs, has been a vexing issue that has dogged these institutions for decades. In a vastly changed international context, in which private sector flows have grown explosively, official flows have stagnated and new forms of financing are being explored, the division of labor and the coordination of actors in the development finance scene acquires renewed importance.

A first issue refers to the *division of labor between MDBs and private sources of capital*. Much conventional wisdom on this subject holds that 'the MDBs have no business lending in countries for sectors in which private financing is available on appropriate terms'.[43] This begs the questions of what are 'appropriate terms' and why a developing country would choose MDBs over private sources if the latter provided financing on such appropriate terms. Moreover, relatively high transaction costs (e.g. long negotiations, tranching, delays, conditionality and loan terms) may offset any price advantage MDBs loans may offer to borrowers. In addition, even in some sectors that may attract private financing, such as infrastructure and telecommunications, loan maturities, conditions for private investment (tax breaks, fiscal incentives) and differences between private and social rates of return may require public financing in one form or another, including MDB participation through loans or guarantees.

A second issue refers to the *division of labor between the MDBs, bilateral agencies, United Nations agencies and regional organizations in mobilizing concessional financing*, especially for the social sectors. The lack of effective donor coordination imposes a heavy burden in many poor countries, where a multiplicity of agencies pose demands on limited administrative and policy making capacities. The financial and administrative capabilities of MDBs may offer advantages in cooperative efforts requiring overall coordination and management, but, as has been previously observed earlier in this connection, there is a substantial gap between rhetoric at headquarters and reality at the field level. Also, the HIPC initiative has brought into sharp focus major inadequacies in past policies and practices of MDBs. Unless these are corrected - which may require significant adjustments in operations and higher administrative costs – any claims to legitimacy by MDBs as coordinators of development efforts will lack credibility.

A further issue and one of growing importance in the division of labor between different development agencies is that of comparative advantage. The established strengths and core competencies of at least some MDBs may be said to lie in 'turnkey' approaches (i.e. design, contracting, financing and execution) to the provision of essential economic infrastructure. Attention has already been drawn to an increasing risk that PRSPs will concentrate overall donor resources on direct social expenditures and away from both essential investments in basic economic infrastructure and adequate attention to macroeconomic fundamentals. Moreover, the PRSPs may also result in 'mission creep' and donor convergence on direct social inventions to reduce poverty. Far from helping to clarify division of labor issues, current processes and instruments may unintentionally serve more to blur boundaries, and add to existing confusion.

---

[43] Lawrence Summers, 'A new framework for multilateral development policy', remarks to the Council on Foreign Relations, New York, NY, March 20, 1999.

In the area of *'soft interventions', which involve primarily setting norms, establishing standards, and providing policy advice, an appropriate division of labor would envisage a larger role for other international institutions*. For example, the World Trade Organization, the International Monetary Fund and some United Nations agencies (UNCTAD, the Regional Economic Commissions) have an advantage over MDBs in trade and financial issues.[44] Specialized United Nations agencies have advantages in their specific fields - for example, the World Health Organization and the Pan-American Health Organization in health - and it is in the interest of the MDBs to strengthen these institutions. Moreover, *other international institutions and private entities, including foundations and non-governmental organizations, have a comparative advantage over the MDBs in small and focused development interventions in the field* (micro credit, vaccination, gender, environmental conservation) and MDBs have began to articulate strategic alliances with them to design and implement projects. Figure 20 summarizes these observations on the division of labor between the family of MDBs and other institutions in the development and the international financial systems.

A third set of issues refers to the appropriate *division of labor between the MDBs themselves*. There have been frequent calls for a clearer definition of responsibilities between the World Bank and the regional development banks and, to a lesser extent, between the regional and the sub-regional development banks. Suggestions have been made to divide responsibilities by sector, by country and even by phase of the project cycle. A division of labor may also be based on a segmentation of products offered by different MDBs. For example, the World Bank is the appropriate institution for offering large scale, fast disbursing, policy-based emergency loans, while regional banks would have a supporting role. Operations in social sectors, and particularly in judiciary reform and public administration, which require a more intimate knowledge of domestic political conditions, may be more appropriate for the regional development banks, with the World Bank and the sub-regional development banks playing a smaller role. Investment projects and programs in infrastructure may be more appropriate for the smaller sub-regional development banks, even though other MDBs would also be involved in these sectors (possibly through private sector guarantees) in countries where there is a high demand for external financing. New fields for MDB interventions, where there is value in sharing experience across regions, may be more appropriate for a global institution like the World Bank, while region-specific problems may be better left to the more focused MDBs.

[44] The current debates on a 'new international financial architecture' focus largely on the appropriate roles of different international institutions in setting financial norms and standards. See Annex J for a discussion of the role of the MDBs in the new financial architecture.

TABLE 15
Division of labor between MDBs and other institutions in the development and the international finance systems

Functions	Multilateral Development Banks			Other institutions				
	WB	**RDBs**	**SRDBs**	**IMF**	**Private sector**	**Bilateral agencies**	**UN and regional orgs.**	**Foundations and NGOs**
Financial resource mobilization	+ + +	+ + +	+ + +	+ +	+ + +	+	—	+
Capacity building, institutional development, knowledge brokering	+ + +	+ + +	+	+	+	+	+ +	+ +
Provision of regional and global public goods	+	+ +	+	+	—	+	+ + +	+ +

Notes: WB, World Bank; RDBs, regional development banks; SRDBs, subregional development banks.
— No role
\+ Minor role
\+ + Moderate role
\+ + + Major role

Mutual suspicion and different institutional personalities have prevented more effective coordination in the MDB system. Asymmetric power relations between the World Bank and the regional development banks, and between these and their sub-regional counterparts have often heightened suspicions and conspired against smooth working relationships. Because of this, efforts to arrive at a fairly complete division of labor and instruments or coordination will continue to be difficult. This suggests that much may be gained through a number of more specific initial efforts aimed at reducing operational overlaps and improving efficiency. This could involve, for example, the harmonization of procedures (as the Arab sub-regional institutions have done), the pooling of staff to undertake special tasks (such as responding to financial crisis and other emergencies), the organization of joint missions to reduce costs (as the World Bank and the African Development Bank plan to do), and the exchange of information and the sharing of knowledge management systems. In addition, MDBs might undertake the task of developing common worldwide strategies in sectors that merit global approaches, such as energy, environment and telecommunications.

A fourth set of issues refers to the activities of MDBs in the field. The question of the division of labor between MDBs, and between them and other development and finance institutions, often looks very different when seen from the perspective of developing countries. Some borrowing countries have expressed a preference for having MDBs compete for projects. In other instances, close collaboration between MDBs and other international financial institutions may be appropriate and even essential. For example, without such collaboration in the early 1990s, it would have not been possible to achieve debt workouts for Latin American countries in arrears with international financial institutions. In the Peruvian case, the IMF, the World Bank, the Inter-American Development Bank and the Latin

American Reserve Fund all acted in concert, with the support of bilateral donors (mainly Japan and the United States), to assist the country in normalizing its payments situation with MDBs and other creditors. Resources provided by one institution were used to clear arrears with another, and so on, until all arrears were cleared. Peru then returned to good standing and a viable financing package was structured for the medium term.

Finally, the absence of subregional development banks in Asia stands in clear contrast with the situation in other regions, especially given the size and diversity of the Asian countries. Although governments showed no inclination in the 1990s for the establishment of new international institutions, recent events suggest that this may an appropriate time to explore the merits of establishing at least one subregional MDB in order to address important new challenges. For example, the integration of North Korea into the international financial community, which has recently been placed on the agendas of the World Bank and the Asian Development Bank, could be perhaps better addressed through a new development bank. This new institution could focus on the development of physical and social infrastructure of North Korea and the border between North and South Korea, as well as on fostering environmental cooperation and promoting the development of the Tumen river basin shared by North Korea, China and Russia (where a UNDP program if already under way). In addition to these countries membership in the new subregional development bank could include Japan, the AsDB and the EBRD.

5.5 *Capital adequacy of the MDBs and the impact of the HIPC initiative*

An adequate capital and financing structure is fundamental for MDBs to fulfill their triple role, for these are essential to their financial integrity and their capacity to lend. Without their resource mobilization functions MDBs would lose one of the essential characteristics that have made them a lasting and successful institutional innovation. In addition to maintaining the political support of shareholders (Section 5.2), preserving the financial integrity of MDBs requires achieving *consistently good financial ratios,* especially in relation to risk-bearing capital.

There are two effective ways for MDBs to strengthen their financial positions and bolster their risk-bearing capacity. The first is a *general capital increase,* which could also involve increases in the paid-in portion, and the second is to *increase loan charges*, which would bolster operating and net income, and thus allow the build up of reserves. Other options (e.g. work to reduce cost of borrowing, assuming higher risks in managing liquidity, loan securitization, and reducing administrative expenses) would contribute to only a very limited extent.

The various *MDBs are in different situations with respect to capital needs to support their regular lending operations*. At approximately current levels of lending (which came down sharply after the Asian crisis) the World Bank would not need a capital increase for another seven to ten years. The Inter-American Development Bank is in a comfortable position and may not need a capital increase for a considerable time, and the European Bank for Reconstruction and Development is in the same situation. The African Development Bank increased its capital recently, and future increases will depend on how well it performs in the short and medium term. For almost all of the larger MDBs, therefore, current trends, indicate that capital increases will not be required for some time. If, however, a major role in emergency lending by any of the MDBs to middle income countries were emerge, then the capital adequacy issue would have to be revisited.

The situation of the Asian Development Bank is quite different. Its traditional financial management was quite conservative and it was seriously affected by the 1997-1998 crisis. Of all the larger MDBs, it is most in need of a capital increase. Its authorized capital is less than half of that of the Inter-American Development Bank, even though it has a larger and more diverse constituency of borrowers to serve.

The situation with regard to the sub-regional development banks is less clear, although at current levels of operations it appears that the European Investment Bank, the Islamic Bank, the Arab Fund and the Andean Finance Corporation are adequately capitalized for the next several. The Central American Bank for Economic Integration, however, is experiencing financial difficulties, partly as a result of the HIPC initiative, and may require a capital increase very soon.

Even though negative net transfers may be considered a ‘rite of passage’ and not a hazard to financial health for the better off developing countries, they pose serious problems for low-income countries that are unable to grow and for those that, in spite of fast growth, still have a large proportion of their populations below the poverty line. The subset of poor borrowing countries is larger than the subset of middle and high-income borrowers, and their financing needs are much greater. As a consequence, the aggregate loan portfolios of the MDBs should grow steadily so as to maintain positive net transfers with borrowing members. However, if the MDB system as a whole, or for that matter any of its members, wish to maintain positive net transfers with its borrowers in the long run, *further capital increases would be necessary in the medium to long-term.* In this regard, it is worthwhile mentioning that a the end of the 1990s the US was not prepared even to discuss possible capital increases for the MDBs, and in particular for the Asian Development Bank and the World Bank.

All *MDBs face restrictions regarding their soft loan windows, to the extent of generating doubts about the future prospects for concessional lending*. It appears that the best hope in the near term is that the total volume of Official Development Assistance, both through multilateral and bilateral channels, will remain at current levels in nominal terms. This, of course, implies a decline in real terms. Donors committed to achieving the poverty reduction targets for 2015 and wishing the MDBs to play a significant role in this regard, should ensure that the concessional windows of MDBs remain at least at current levels, after taking into account their contributions to the HIPC Trust Fund.

The HIPC initiative has important implications for the financial situation of the MDBs most affected by it. Unless funded fully and on a timely basis, debt cancellation could reduce the total amount of concessional resources available for the poorest countries, primarily because reflows would be significantly lowered. The total cost of the enhanced HIPC initiative is estimated to be US$ 28.2 billion in 1999 net present value terms, about 40 percent of which corresponds to the MDBs. As of June 30,2000, pledges to the HIPC Trust Fund added to about US$ 2.5 billion, slightly less than a quarter of the required amount.

Donors facing high HIPC costs for their bilateral programs may have a difficult time contributing both to the HIPC Trust Fund and to subsequent replenishments of the concessional windows of the MDBs. A combination of lower reflows and stagnant replenishments would have serious implications for the future role of MDBs in responding to the needs of the poorest countries. This is of crucial importance to those HIPC countries whose sustainable level of borrowing after debt relief can be achieved only on the basis of grants and IDA terms (See Section 4.6).

It is not exaggerated to observe that, unless full and timely funding is made available to HIPC and to future soft-loan window replenishments, at least some of the poorest countries may end up worse in the medium and long term, after the HIPC process has cancelled their debts.

5.6 *Relationship with borrowers and income management policies*

The new client orientation of the MDB and the desire to increase local ownership of external assistance programs suggests that developing countries should interact with MDBs, and particularly with the World Bank, in a less asymmetrical manner than has been customary. For this to happen, capabilities in domestic policy analysis and in program and project design and implementation will need to be supported. Putting developing country governments in the driver's seat is essential for the success of externally supported development programs, and even though there is an imperative role for MDBs in helping the driver to obtain his license, they should rapidly become agreeable passengers and refrain from back seat driving.

MDBs, and in particular the World Bank, should change the way they relate to borrowers. MDBs have accumulated a broad base of knowledge about development policies and strategies, and could thus become 'knowledge institutions,' ready to learn and adapt on the basis of experience. However, they apparently find it difficult to do so. Even though other MDBs have tried to build their own research and policy advice capacities, the World Bank continues to be the main purveyor of development ideas. Although its policy prescriptions change significantly over time (e.g. shifts in policy advice on the role of the State, on financial liberalization), a 'the Bank can never be wrong' mentality still permeates much of the institution's thoughts and actions. This impairs the World Bank's ability to learn and creates an accountability deficit. Nevertheless, over the past three years the World Bank has placed about half of its country directors and about a quarter of its staff in the field. This may indicate a serious intent to break with past practices and may signal the beginning of a new approach in its relations with borrowers.

By contrast to approaches and attitudes that have long been associated with the World Bank, some sub-regional MDBs appear overly willing to defer to the governments of their borrowing country members. The effects of this can serve to undermine sound policy advice and the requirements of sound macroeconomic management.

The Comprehensive Development Framework (CDF) and the Poverty Reduction Strategy Papers (PRSP) could be used to engage borrowers in a more meaningful dialogue with the MDBs and with other development assistance agencies. However imperfect their application may be, especially when viewed from the ground up, they are preferably to previous practices where country assistance strategies were often unilaterally designed by MDB staff. Nevertheless, for these instruments to play a positive role MDBs should be prepared to accept strategies and policies different from those they espouse and to collaborate with other institutions and organizations, particularly to integrate institutional considerations into the design of CDFs and PRSPs.

Greater interaction with borrowing country members requires staff time, intensive consultations and possibly a more substantive field presence. In turn, this raises the cost of doing business for MDBs, and is one of the multiple pressures that are being exerted on the management of operating and net income.

If the MDBs are to play the roles that they should and are expected to, *increases to operating and net income will be required*. This is the only way to cover administrative costs, increase reserves, make transfers to soft-loan windows and provide grants to finance public goods. Decisions on the management of operating and net income - which are closely related to decisions on capital increases and loan charges - should be based on strategic views on the roles MDBs will play in the future. It is important that the costs of increasing operating and net income be equitably distributed among shareholders, seeking to balance increases in callable and paid-in capital, increases in loan charges, charges for non-lending services, and pressures on staff to reduce administration costs.

In addition, much greater flexibility in budget procedures and multi-annual budgets are also essential to improve the administration of MDBs, allowing them to make a more efficient use of resources. This would require a major shift from the public agency style of budget management of MDBs, which involves a fair degree of Board micro-management, to a style of budget management more in tune with modern resource allocation and use practices (decentralization, cost centers, performance indicators, outcomes and results accountability).

6. CONCLUDING REMARKS

The development cooperation experiment has now passed its half-century, and during the last five decades the concept and the practice of development have evolved and adapted to changing circumstances. However, as the 21st century begins, the institutional arrangements at the intersection of the international development system and the international financing system are under severe stress. The emergence of a fractured global order and the differentiation of developing countries have created a new context and requires rethinking the objectives, instruments, institutions and basic assumptions that underpin development efforts. Indeed, the very idea of 'development' needs to be reexamined.

But whatever new meanings the concept of development may assume in the decades ahead, there will be a continuing need for assisting poorer countries to improve their living standards, primarily by mobilizing financial resources, helping to build capabilities and institutions, sharing knowledge, and providing regional and global public goods. Many international, regional, bilateral, private and non-governmental institutions have undertaken these tasks during the last fifty years. Among these, and in spite of their shortcomings and limitations, multilateral development banks stand out as one of the most effective institutional innovations of the last half-century. However, their usefulness has come under attack from many quarters - especially during the last decade - in no small part because some of their major mistakes have been widely publicized.

There many ways in which MDB performance can be improved and there is no shortage of advice and suggestions on how to do so. But this should not prevent observers from realizing that, considered as a whole MDBs have a positive track record and there are no comparable institutions that provide a similar range of products and services to their member countries. Whether or not this allows for the cliché 'if they did not exist, it would be necessary to create them,' the fact is that, with the possible exception of automatic resource mobilization mechanisms (e.g. international taxes), there are no other similarly effective institutional innovations yet in sight.

Shareholders and senior MDB staff should react with a sense of urgency to the challenges implied by the major transformations that are now under way in the international context. In particular, there is an important role for concerned small non-borrowing shareholders in support of the MDBs. Many of these participate in several MDBs, which gives them a broad perspective on the operations of these institutions as a whole. They should help articulate a shared perspective of the future of MDBs, acknowledging their limitations and shortcomings, but forcefully mobilizing support for their continued existence and gradual expansion.

In addition to paying attention to the World Bank and the regional development banks, it is necessary to pay greater attention to the smaller sub-regional banks. They often play an important role when viewed from the perspective of the borrowing countries, and should intensify and improve their interactions with other members of the MDB family. Also, the absence of sub-regional institutions in a region as large and diverse as Asia is quite striking and merits further examination.

Under attack from both conservative and radical positions, the multilateral development banks need champions among their smaller non-borrowing shareholders. Their motivations are less suspect than those of big developed country shareholders and of borrowing member countries, they understand well the strengths and weaknesses of MDBs, and they are well poised to exert leadership in a renewal of a somewhat disparate family of rather unique and most useful set of institutions.

ANNEXES

ANNEX A

Table A-1
Categories and developing and transition countries according to the Development Assistance Committee (DAC)

Part I: Developing Countries and Territories (Official Development Assistance)								Part II: Countries and Territories in Transition (Official Aid)	
Least Developed Countries	**HDI**	**Other Low Income Countries**	**HDI**	**Lower Middle Income Countries and Territories**	**HDI**	**Upper Middle Income Countries and Territories**	**HDI**	**Central and Eastern European Countries and New Independent States of the former Soviet Union**	**HDI**
Afghanistan		* Albania	0.721	Algeria	0.683	Brazil	0.747	* Belarus	0.781
Angola	0.405	* Armenia	0.713	Belize	0.777	Chile	0.826	* Bulgaria	0.772
Bangladesh	0.461	* Azerbaijan	0.722	Bolivia	0.643	Cook Islands		* Czech Republic	0.843
Benin	0.411	Bosnia and Herzegovina		Botswana	0.593	Croatia	0.795	* Estonia	0.801
Bhutan	0.483	Cameroon	0.528	Colombia	0.764	Gabon	0.592	* Hungary	0.817
Burkina Faso	0.303	China	0.628	Costa Rica	0.797	Malaysia		* Latvia	0.771
Burundi	0.321	Congo, Rep.	0.507	Cuba	0.783	Mauritius	0.761	* Lithuania	0.789
Cambodia	0.512	Côte d'Ivoire	0.420	Dominica	0.793	§ Mayotte	-	* Poland	0.814
Cape Verde	0.688	* Georgia	0.762	Dominican Republic	0.729	Mexico	0.784	* Romania	0.770
Central African Republic	0.371	Ghana	0.556	§ East Timor		Nauru		* Russia	0.771
Chad	0.367	Guyana	0.709	Ecuador	0.722	South Africa	0.697	* Slovak Republic	0.825
Comoros	0.510	Honduras	0.653	Egypt	0.623	St Lucia	0.728	* Ukraine	0.744
Congo, Dem.Rep.	0.430	India	0.563	El Salvador	0.696	Trinidad and Tobago	0.793	HDI Average	0.792
Djibouti	0.447	Kenya	0.508	Fiji	0.769	Uruguay	0.825	Standard Deviation	2.87%
Equatorial Guinea	0.555	* Kyrgyz Rep.	0.706	Grenada	0.785	HDI Average	0.755		
Eritrea	0.408	Mongolia	0.628	Guatemala	0.619	Standard Deviation	7.04%		
Ethiopia	0.309	Nicaragua	0.631	Indonesia	0.670				
Gambia	0.396	Nigeria	0.439	Iran	0.709				
Guinea	0.394	Pakistan	0.522	Iraq	0.583	**Threshold for World Bank Loan Eligibility**	**HDI**		
Guinea-Bissau	0.331	Senegal	0.416	Jamaica	0.735				
Haiti	0.440	Sri Lanka	0.733	Jordan	0.721				
Kiribati		* Tajikistan	0.663	* Kazakstan	0.754	§ Anguilla			
Laos	0.484	Viet Nam	0.671	Korea, Democratic Republic of		Antigua and Barbuda	0.833		
Lesotho	0.569	Zimbabwe	0.555	Lebanon	0.735	Argentina	0.837		
Liberia				Macedonia (former Yugoslav Republic)	0.763	Bahrain	0.820		
Madagascar	0.483			Marshall Islands		Barbados	0.858		
Malawi	0.385			Micronesia, Federated States		Libya1	0.760		
Maldives	0.725			* Moldova	0.700	Malta	0.865		
Mali	0.380			Morocco	0.589	§ Montserrat	-		
Mauritania	0.451			Namibia	0.632	Oman	0.730		
Mozambique	0.341			Niue		Saudi Arabia	0.747		
Myanmar	0.585			Palau Islands		Seychelles	0.786		

Part I: Developing Countries and Territories (Official Development Assistance)								Part II: Countries and Territories in Transition (Official Aid)	
Least Developed Countries	**HDI**	**Other Low Income Countries**	**HDI**	**Lower Middle Income Countries and Territories**	**HDI**	**Upper Middle Income Countries and Territories**	**HDI**	**Central and Eastern European Countries and New Independent States of the former Soviet Union**	**HDI**
Nepal	0.474			Palestinian Ad. Areas		Slovenia	0.861		
Niger	0.293			Panama	0.776	§ St Helena			
Rwanda	0.382			Papua New Guinea	0.542	St Kitts and Nevis	0.798		
Samoa	0.711			Paraguay	0.736	§ Turks and Caicos Islands		**More Advanced Developing Countries and Territories**	**HDI**
Sao Tome and Principe	0.547			Peru	0.737	HDI Average	0.809		
Sierra Leone	0.252			Philippines	0.744	Standard Deviation	4.78%		
Solomon Islands	0.614			St Vincent & Grenadines	0.738				
Somalia				Suriname	0.766			Bahamas	0.844
Sudan	0.477			Swaziland	0.655	**High Income Countries and Territories**	**HDI**	§ Bermuda	
Tanzania	0.415			Syria	0.660			Brunei	0.848
Togo	0.471			Thailand	0.745			§ Cayman Islands	
Tuvalu				§ Tokelau		§ Aruba[1]		Chinese Taipei	
Uganda	0.409			Tonga		§ French Polynesia[1]		Cyprus	0.886
Vanuatu	0.623			Tunisia	0.703	§ Gibraltar[1]		§ Falkland Islands	
Yemen	0.448			Turkey	0.732	Korea, Rep. Of[1]	0.854	§ Hong Kong, China	0.872
Zambia	0.420			* Turkmenistan	0.704	§ Macao[1]		Israel	0.883
				* Uzbekistan	0.686	§ Netherlands Antilles[1]		Kuwait	0.836
				Venezuela	0.770	§ New Caledonia[1]		Qatar	0.819
				§ Wallis and Futuna		Northern Marianas[1]		Singapore	0.881
				Yugoslavia, Federal Republic		§ Virgin Islands (UK)[1]		United Arab Emirates	0.810
HDI Average	0.453	HDI Average	0.607	HDI Average	0.709	HDI Average	0.854	HDI Average	0.782
Standard Deviation	11.1%	Standard Deviation	10.6%	Standard Deviation	6.5%			Standard Deviation	2.9%

Notes:

* Central and Eastern European countries and New Independent States of the former Soviet Union (CEECs/NIS) Territory

1. These countries and territories transferred to Part II on 1 January 2000.

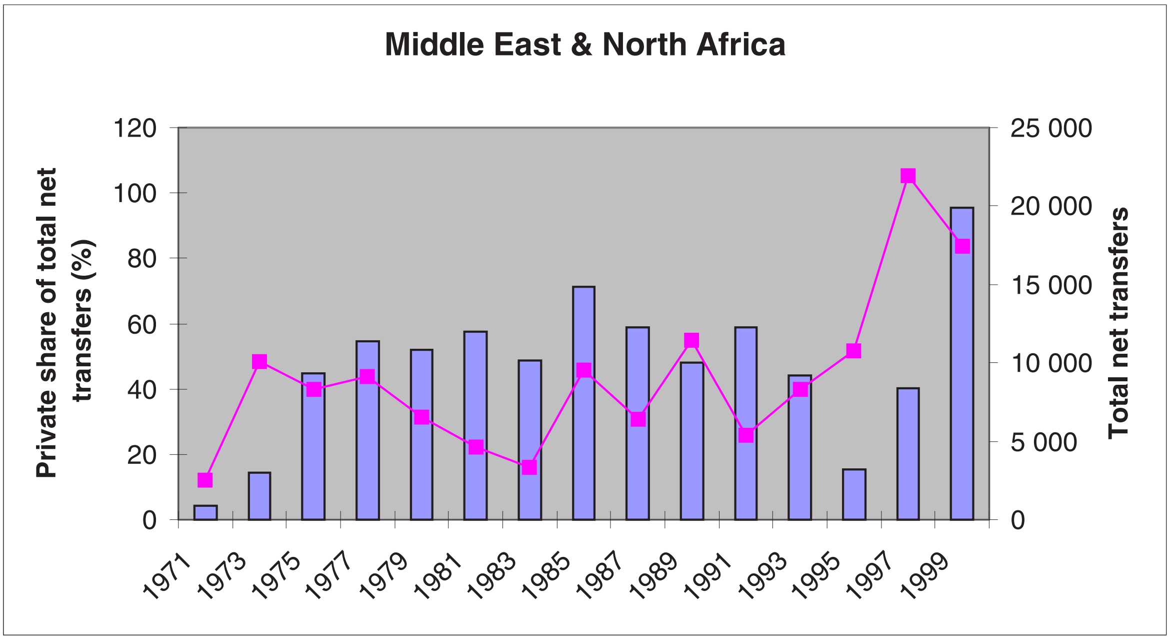
Source: DAC list from OECD website http://www.oecd.org

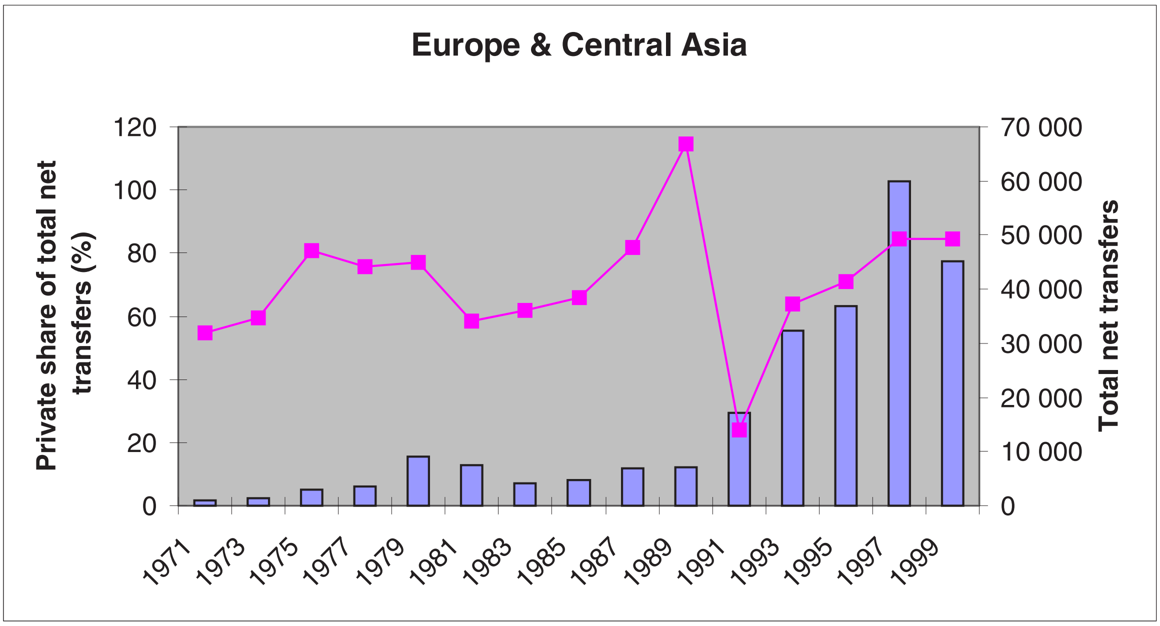
HDI form United Nations Development Program, *Human Development Report 2000*, New York, Oxford University Press, 2000.

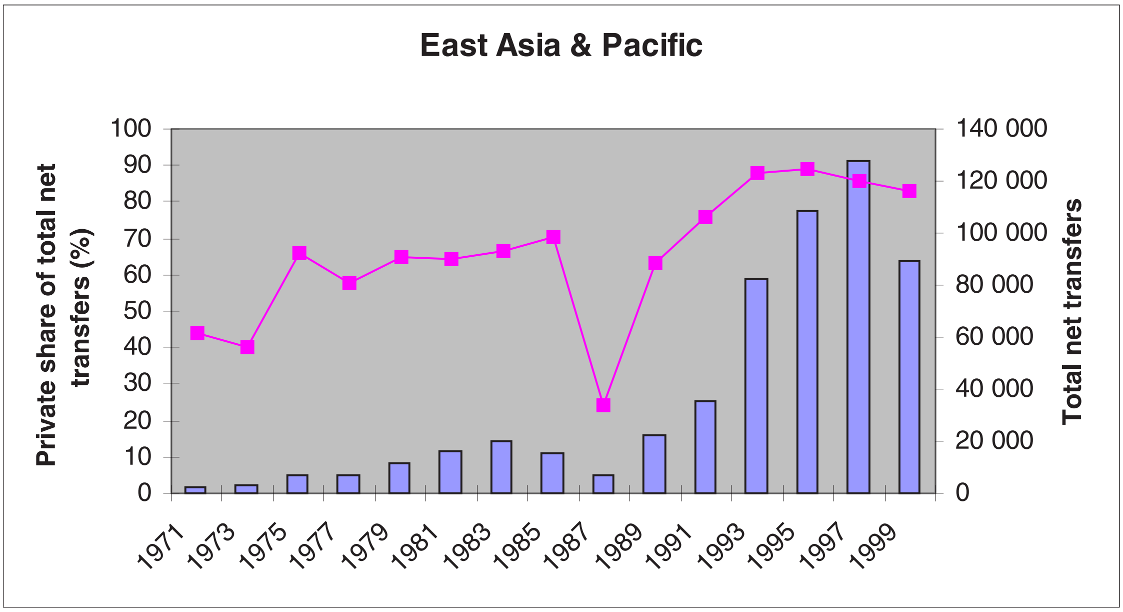
ANNEX A

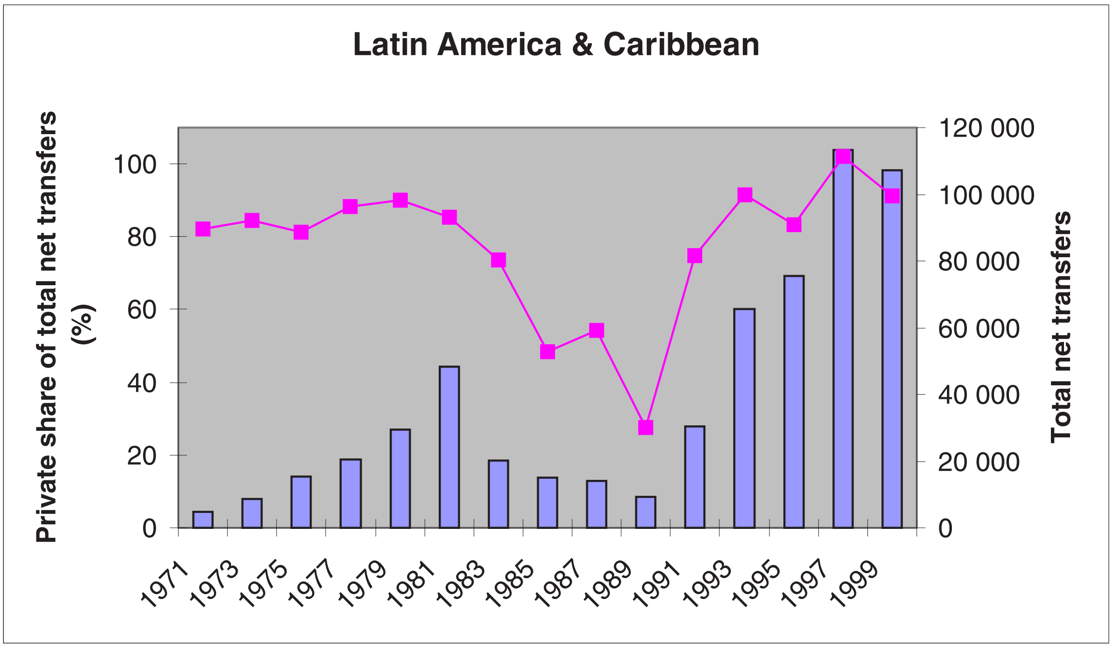
FIGURE A - 1

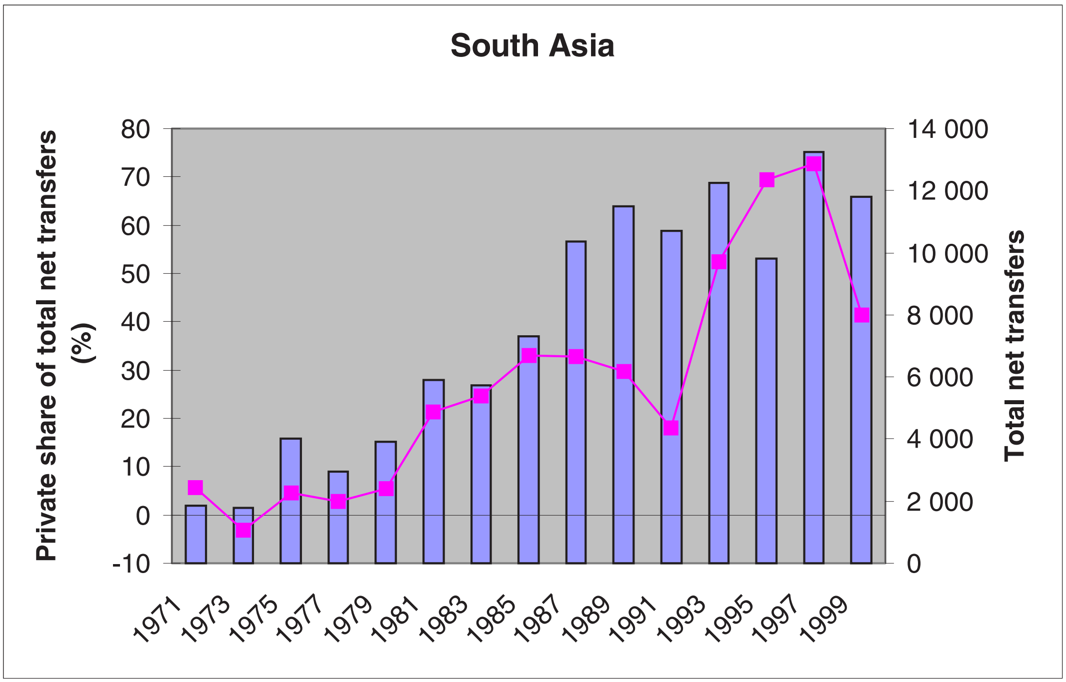
Shares of private flows in total resources flows by region






East Asia & Pacific
Private share of total net transfers (%)
Total net transfers
100
90
80
70
60
50
40
30
20
10
0
140 000
120 000
100 000
80 000
60 000
40 000
20 000
0
1971
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999


Latin America & Caribbean
Private share of total net transfers (%)
Total net transfers
100
80
60
40
20
0
120 000
100 000
80 000
60 000
40 000
20 000
0
1971
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999


South Asia
Private share of total net transfers (%)
Total net transfers
80
70
60
50
40
30
20
10
0
-10
14 000
12 000
10 000
8 000
6 000
4 000
2 000
0
1971
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999

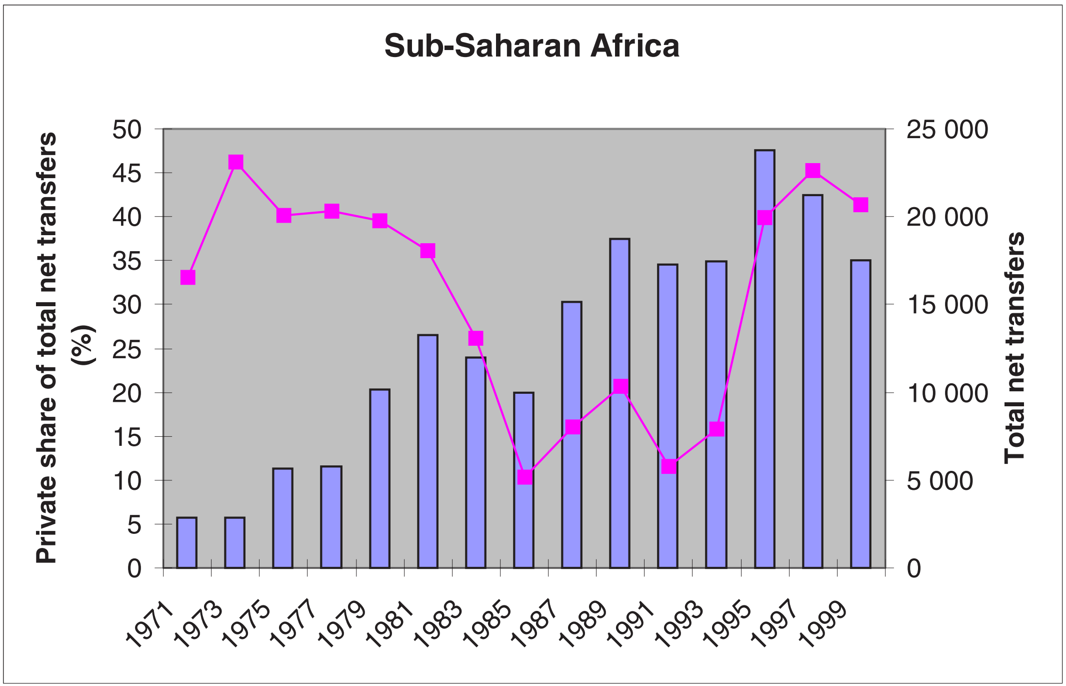
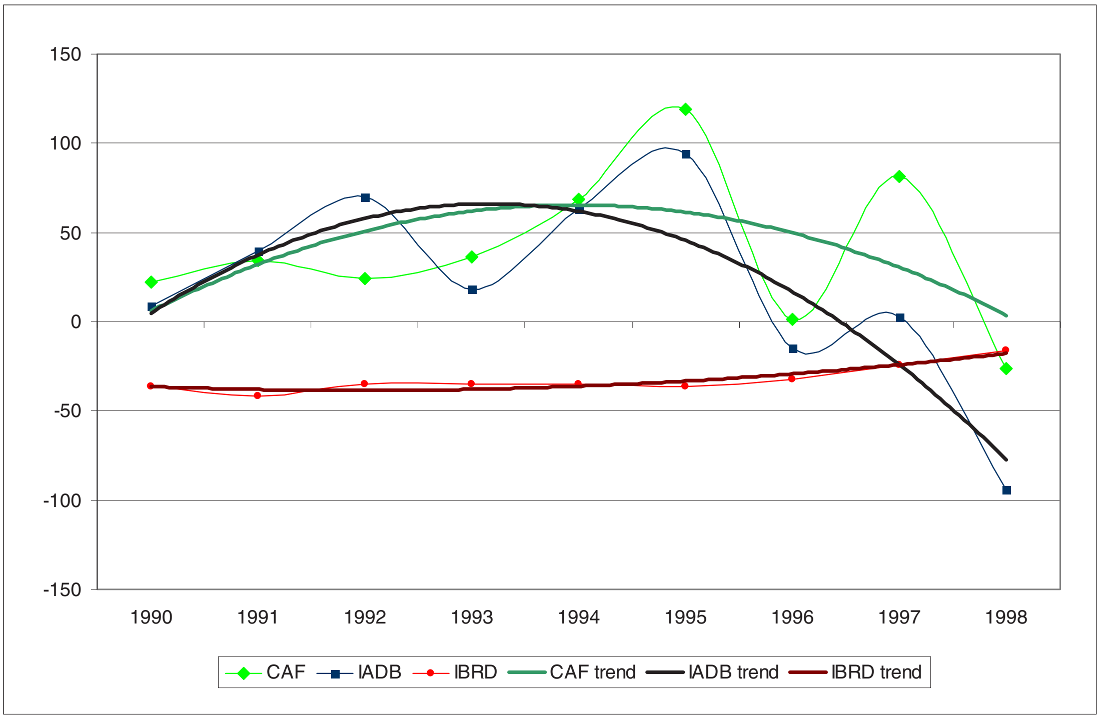
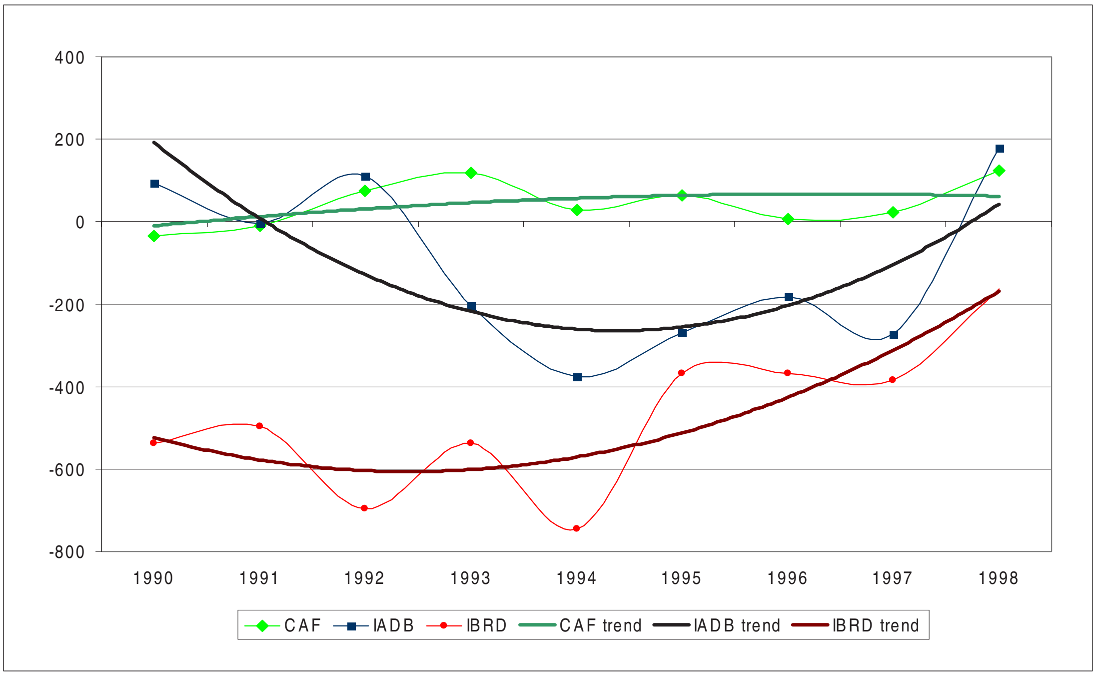

Sub-Saharan Africa
Private share of total net transfers (%)
Total net transfers
50
45
40
35
30
25
20
15
10
5
0
25 000
20 000
15 000
10 000
5 000
0
1971
1973
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999

FIGURE A-2a
Total net transfers of IBRD, IADB and CAF to Bolivia
(US$ million)



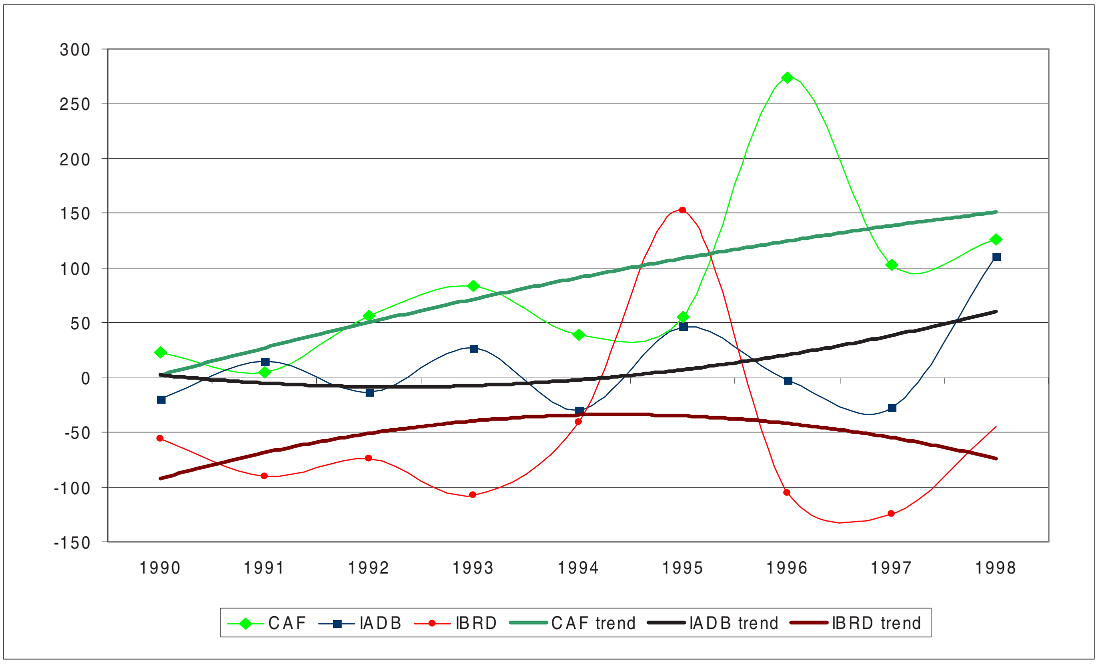
Source: World Bank, Global Development Finance 2000, (CD ROM),
Corporación Andina de Fomento

FIGURE A-2b
Total net transfers of IBRD, IADB and CAF to Colombia
(US$ million)



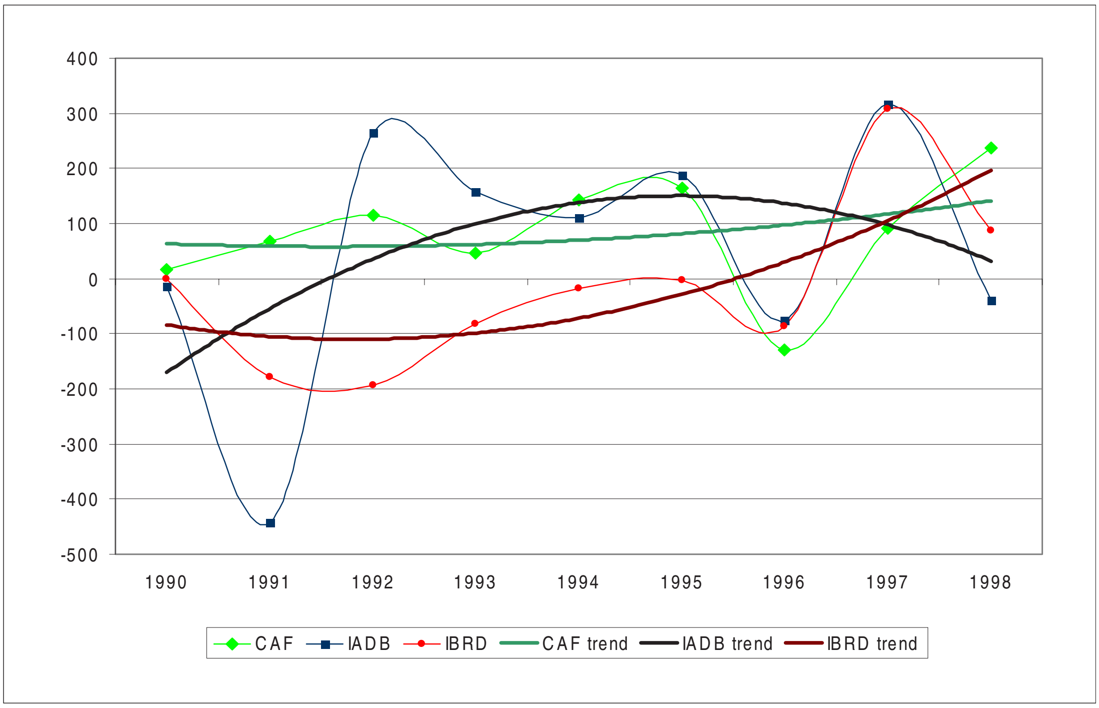
Source: World Bank, Global Development Finance 2000, (CD ROM)
Corporación Andina de Fomento

FIGURE A-2c
Total net transfers of IBRD, IADB and CAF to Ecuador
(US$ million)



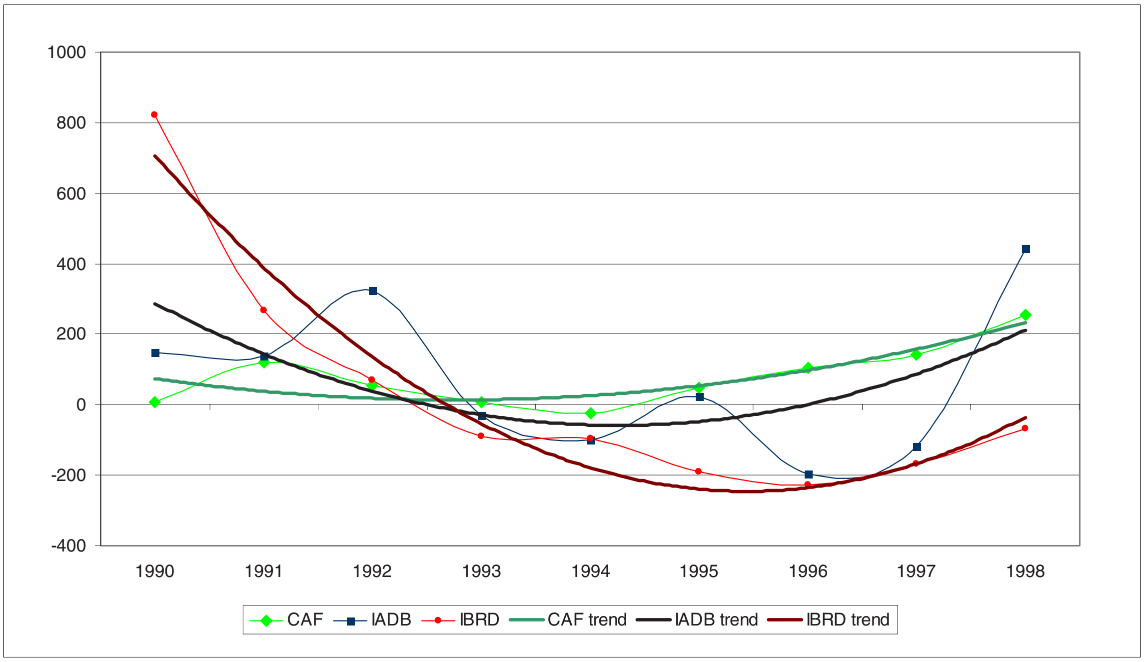
Source: World Bank, Global Development Finance 2000, (CD ROM)
Corporación Andina de Fomento

FIGURE A-2d
Total net transfers of IBRD, IADB and CAF to Peru
(US$ million)



Source: World Bank, Global Development Finance 2000, (CD ROM)
Corporación Andina de Fomento

FIGURE A-2e
Total net transfers of IBRD, IADB and CAF to Venezuela, RB
(US$ million)



Source: World Bank, Global Development Finance 2000, (CD ROM)
Corporación Andina de Fomento

ANNEX B

The origins and evolution of the development cooperation experiment

What may be called the ‘development cooperation experiment’ of the past fifty years, aimed at improving living standards in poor countries, took place at a very special period of history. The end of World War II, the Cold War and a process of economic internationalization provided a backdrop for the evolution of development thinking and practice, and also for the creation of development cooperation institutions and instruments.

The creation of the World Bank (International Bank for Reconstruction and Development or IBRD) - together the International Monetary Fund - at Bretton Woods in 1944 was aimed at assisting the reconstruction efforts of countries affected by World War II. However, as the Marshall Plan sidelined the newly established institution and reconstruction financing subsided, the World Bank centered its subsequent efforts on providing financial and technical assistance for development. As the World Bank gradually established its reputation as a good borrower in the international capital markets and expanded its financial intermediation role, and as its private sector and concessional lending affiliates were established, the basic features of the family of Multilateral Development Banks began to emerge.

The successful implementation of the Marshall Plan inspired a belief in the effectiveness of foreign assistance programs. This gave a major boost to the development cooperation experiment. In a display of exceptionally enlightened self-interest, between 1947 and 1951 the United States injected the 1997 equivalent of $88 billion in balance of payments support, financial assistance and soft loans to most countries in Western Europe, and also provided technical assistance and access to US managerial and manufacturing know-how.

Faith in the possibility of development was sustained and reinforced by the economic successes of the postwar decades. During the period from the late 1940s to the early 1970s, the world economy grew practically everywhere at an unprecedented pace. Jump-started by the financial resources, capital and consumer goods, and technical assistance of the Marshall Plan, European economies recovered and grew at nearly 5 percent per year. Led by Japan, the economies of Asia registered an average annual growth rate of 6 percent, while Eastern Europe grew at 4.7 percent, Latin America at 5.3 percent, and even Africa showed a growth rate of 4.4 per year. These growth rates could not be replicated in all regions in subsequent decades.

The early decades of the development cooperation experiment coincided with a Golden Age of world economic growth. This unprecedented period of international prosperity was also a period of considerable international generosity and led to a major expansion of international cooperation. Following the success of the Marshall Plan, the United States launched the Point Four Program to expand bilateral aid to developing countries in 1949 and created the Technical Cooperation Administration to administer this program. For the next two and one half decades, resources to assist poor countries steadily increased and a large array of bilateral and multilateral institutions were created to channel and administer these resources.

Bilateral and multilateral channels for development cooperation

Notwithstanding the creation of the World Bank, between the late 1940s and the early 1960s development assistance was mostly bilateral. Strategic and security interests, linked to the containment of communism in the context of the Cold War, provided the main motivation for engaging in international cooperation for development. The United States accounted for more than 50 percent of total Official Development Assistance (ODA) during the 1950s and for about 45 percent in the early 1960s, out of which about more than 85 percent were provided through bilateral channels.

Between 1958 and 1966 the World Bank was joined by three regional MDBs in Latin America, Asia and Africa, each of which also established their soft-loan affiliates to provide financing in concessional terms. According to the Pearson report, published in 1969, by the mid-1960s the combined share of multilateral channels accounted for about 10 percent of Official Development Assistance (ODA) flows. The Pearson report proposed strengthening multilateral channels, which at that time were perceived to be more efficient and less politicized than bilateral aid.

From the mid-1960s to the mid-1970s multilateral assistance expanded faster than bilateral aid and its share in total development assistance grew to about 25 percent. A number of regional initiatives, such as the Arab and the OPEC development funds, the Regional Program for Scientific and Technological Development of the Organization of American States, and the Colombo Plan for education in South and East Asia, complemented the range of multilateral development assistance programs and institutions.

Three main reasons accounted for the relative expansion of development financing through multilateral channels during the 1960s and 1970s.

First, the United States became more interested in multilateral initiatives, particularly as the capacity of its aid delivery organizations began to reach its limits. The growing demands of an increasing number of developing countries following the process of decolonization, together with the shift from reconstruction of war-torn economies toward more complex development programs, made it more difficult for the United States to respond adequately on its own to these demands. In addition, under the provisions of the United States Foreign Assistance Act of 1973, resources for development assistance were reoriented toward problems such as poverty alleviation, basic human needs and agricultural and rural development, which were common to many developing countries and could be better addressed through multilateral initiatives.

Second, the Nordic countries (Sweden, Norway, Denmark, and Finland), Canada, and the Netherlands responded quite vigorously to the United States' appeal for burden-sharing and gave high priority to multilateral channels. They allocated a significant amount of resources for development assistance to multilateral institutions, particularly to agencies in the United Nations system such as the United Nations Development Program (UNDP). Regional multilateral development channels, such as the regional development banks and the development assistance funds of the European Community, also expanded their activities in a major way.

Third, multilateral development institutions improved significantly their financial, administrative and technical capacities, which increased their access to the international capital markets and earned them the support of donor countries. Particularly notable were the major changes brought to the World Bank under the McNamara presidency (1968-81), including a major expansion of borrowing and lending, a significant reorientation toward poverty alleviation and the strengthening of the World Bank's research capacity. The United Nations Development Program also expanded its in-house technical and administrative capabilities, particularly during Bradford Morse's tenure as UNDP Administrator, and built a strong network of resident representatives in most of the developing countries.

Following this rapid rise through the mid-1970s, the share of multilateral development finance in total official development finance stabilized at about 30 percent through the 1980s. However, this stability concealed a trend towards 'bilateralism in multilateral aid' which became evident as the international context for development assistance began to change. The dominant position of the United States weakened significantly in the second half of the 1980s, as its share of total Official Development Assistance (ODA) declined to about 18 percent and its share of multilateral concessional aid to about 16 percent. This reduction coincided with a shift towards greater emphasis on bilateral security and political interests in the provision of aid, away from the priority awarded to multilateral initiatives a decade earlier. For example, the security-oriented Economic Support Fund, which provides assistance to countries of strategic interest to the United States, grew faster than other types of development assistance. In the late 1980s it accounted for about 50 percent of total United States bilateral aid, with 90 percent of its funds earmarked for five countries (Israel, Egypt, Pakistan, El Salvador and the Philippines).

Japan had been among the top five donor countries since the 1960s, and its development assistance program expanded rapidly during the 1980s. It also shifted from rather narrow bilateral economic interests, such as promoting exports and investments in the Asian region, to broader multilateral considerations related to international economic and international political stability. The increasingly important role played by Japan in the world economy and the relative weakness of its development assistance organizations, led to a growing reliance on multilateral institutions to channel Japanese aid. This took the form of greater participation in MDB loans through co-financing and in multilateral concessional assistance funds, such as IDA at the World Bank and AsDF at the Asian Development Bank, as well as through the establishment of trust funds in international financial institutions. These initiatives allowed Japan to exert greater influence in the policies and practices of these organizations, to maintain a separate identity for its aid funds, and to pursue a policy of 'moderate bilateralism' in multilateral assistance.

Transition in the 1980s and 1990s

Following the international debt crisis that was triggered in 1982 by the Mexican default of its commercial bank loans, the role of multilateral development finance, and particularly that of the MDBs, changed significantly. The International Monetary Fund (IMF) established the Structural Adjustment Facility and the Enhanced Structural Adjustment Facility (SAF/ESAF), the World Bank launched Structural Adjustment Lending (SAL), and regional MDBs created their own fast disbursement lending instruments. This helped many developing countries to weather their liquidity and insolvency crises during the 1980s, but often at the price of adopting painful economic adjustment policies and of increasing the share of preferred and rather inflexible debt owed to MDBs.

The 'disciplinary functions' of the Bretton Woods institutions increased with the growing importance of highly conditioned loans, and an IMF program became a condition, not only for loans and concessional assistance from the MDBs, but also for co-financing from bilateral donors and for loans by commercial banks. The Special Program of Assistance to Low-Income Debt Distressed Countries in Sub-Saharan Africa (SPA), launched in 1988, provided a clear example of the increasing reliance of bilateral donors on multilateral institutions. A Policy Framework Paper (PFP), drawn primarily by the IMF and the World Bank in consultation with government authorities, became a prerequisite for mobilizing large amounts of bilateral funds from donor countries.

From the early 1980s to the early 1990s, the share of multilateral development finance in total official development finance declined steadily from about 30 to 20 percent, even though there was a swift rise from 20 to over 50 percent between 1995 and 1997 as a result of the Asian financial crisis. This has subsided, and the share of multilateral flows is now returning to its pre-crisis level.

Over the half century of the development cooperation experiment, development assistance organizations grew in number, size and complexity, and their mandates shifted and evolved to accommodate changing circumstances. New institutions, programs, funding mechanisms and procedures were created in most developed countries to assist the developing nations. In parallel with these government and intergovernmental initiatives, private giving by foundations, charitable institutions and religious groups supported a growing number of programs and projects throughout the developing world.

As a result, there emerged a vast, dense and at times almost impenetrable forest of development assistance organizations. As these agencies demanded counterparts, a corresponding assortment of government and non-governmental organizations was often established in developing countries to work with donor agencies, international financing institutions and private aid entities. By the time the development experiment reached its fourth and fifth decades, the growing and increasingly complex set of organizational arrangements, a result of incremental institutional innovations, became rather heavy and unwieldy. Turf battles became frequent, accountability all but disappeared, reorganizations followed one after another, and many development assistance organizations lost their sense of purpose and direction. All of this heightened by aid fatigue and a stagnation and even decline in the level of resources available for development cooperation.

By the end of the 1980s, the limitations and shortcomings of the decades-old institutional arrangements for development cooperation —including the MDBs— became evident. This coincided with a new ideological orientation of government in many industrialized nations. Seeking to reduce government spending, conservative politicians in several developed countries found an easy target in foreign aid programs, which were depicted as being wasteful and ineffective. Individual initiative and the private sector were heralded as the new harbingers of economic growth and development, and in some extreme views development assistance was considered as nothing but dependency-generating handouts. This happened at time when a large number of developing countries had experienced several years of economic downturn and a severe debt crisis, which made the

1980s a 'lost decade' in terms of improvements in living standards for most of Latin America, Africa and many countries in Asia.

Development finance and international cooperation have undergone fundamental changes during the last two decades, and the 50-year old institutional arrangements associated with the development cooperation experiment are now struggling to adapt to the new circumstances. In particular, Official Development Assistance (ODA) flows have lost ground in relation to direct foreign investment, portfolio flows to emerging stock markets and commercial bank lending —even though these private flows concentrate mostly on a few emerging countries and bypass completely the vast majority of poor countries. Aid fatigue became common in most of the rich donor nations, and ODA stagnated in nominal terms for most of the 1990s. With the end of the Cold War development assistance flows from the former Soviet Union and East European countries were abruptly cut, and developing countries that relied on Soviet aid found themselves in a very difficult situation.

In contrast with the setbacks experienced during the last decade by traditional bilateral and multilateral development finance, new possibilities are being opened for rich and poor countries to collaborate in some specific fields such as environmental protection, nuclear safety, and the fight against health epidemics. For example, in December 1997 the Parties to the United Nations Framework Convention on Climate Change approved the Kyoto Protocol, which seeks to reduce the emission of gases that contribute to global warming. The Kyoto Protocol establishes a 'clean development mechanism' designed to assist developing countries, which could eventually lead to the transfer of hundreds of millions of dollars annually from rich to poor countries. In 1999 the World Bank has established a 'Prototype Carbon Fund' to facilitate this process.

In addition, during 1990s the ranks of private philanthropic organizations - once the province of religious groups focusing on humanitarian relief and of well-established foundations - have been joined by a few wealthy individuals. For example, George Soros, Ted Turner and Bill Gates created new foundations to channel large amounts of finance to developing countries, transition economies and international institutions. International institutions, and MDBs, United Nations organizations and bilateral agencies have forged strategic alliances with these foundations to work on specific programs and projects such as the Global Alliance for Vaccines Initiative. Moreover, debates about the need for and convenience of establishing some kind of automatic resource mobilization mechanism were revived during the 1990s. A great deal of work has been done on the feasibility of the 'Tobin Tax' on international capital movements, and more recently a 'Bit Tax' on international electronic commercial and financial transactions has been suggested.

Finally, non-governmental organizations (NGOs), which played a limited role channeling the assistance provided by religious groups and private foundations in the early years of the development experiment, became gradually more visible and active both in donor and recipient countries. They began to play a significant intermediary role for bilateral assistance during the 1970s, although most multilateral institutions remained largely aloof towards NGOs until the late 1980s. However, by the mid-1990s their influence and involvement in international development programs had grown significantly, particularly in environmental and social programs, to the extent that even the World Bank and the regional MDBs had to pay more attention to their views.

ANNEX C

Development Thinking and Practice During the last Half-Century[45]

The idea of 'development' - to improve the human condition, to reduce or eliminate oppression, misery and poverty - has been a central feature of human thought for millennia and it has spanned vastly different cultures. 'International development', however, is very much a post-WW II concept. Seared by the traumas of economic depressions and world wars that had characterised the first half of the 20th century, the political and intellectual leaders of the day united in the common cause of 'never again'. The architecture they founded included the United Nations, with a principal mission to prevent and resolve conflict, and the International Monetary Fund and the World Bank to establish economic order and avoid economic catastrophes. Central to their architecture and the institutions resulting from it was the idea of universal development.

Modernisation - The Early Development Years, 1945-1970

This idea was nothing short of revolutionary. Until then, the prevailing view had been that most societies were distinct and essentially non-comparable. To the Western world, the societies of Africa or Asia were viewed as destined to remain distinct and separate. This new idea of universal development placed all societies in the world for the first time on a single and shared continuum from least to most developed, on the same trajectory towards a common development. All of humanity became comparable and all of us were headed to the same place. The defining characteristic of this new vision of universal development was that, within the span of one generation, all parts of the world could achieve through international public actions the standards of living that the rich nations of the West had achieved in three or four generations, but without incurring the heavy social costs that they had to pay or inflicted on others along the way.

The word 'development', however, was rarely used in the early post-war years. Rather, the most frequent formulation involved the concept of 'modernisation'. Modernisation theorists like Ragnar Nurske, W. Arthur Lewes and Walter Rostow were among the early pioneers of international development and they took as their point of departure the notion that the distinguishing feature of developed societies was their economic, social, political and cultural *modernity*. In their conception, such '*modern*' societies were contrasted with *backwardness*, the characteristic of *traditional* societies. To these early thinkers and to the early development movement, development was a matter of modernising traditional societies. The prosperous and expanding urban-industrial sector of richer countries was their development template. Structural transformation from an under-employed rural society to a productive urban-industrial society became the ruling dimension in development thought, policy and practice.

The question at that time was not what to do but how to do it. We must understand the context in which thinking about this question occurred some 50 years ago. Very thoughtful figures like Gunnar Myrdal and Raul Prebish were strongly influenced by the

[45] This annex is based on a contribution to the Encarta cd-rom Encyclopaedia prepared by Keith Bezanson with the assistance of Francisco Sagasti.

experience of successful, state-led economic planning during the war, and also by the war success of the centrally planned Soviet Union. They were also deeply influenced by the Keynesian demonstration of the possibility of an active interventionist macroeconomic full employment policy as well as the experiences of Roosevelt's New Deal and the creation of a national social welfare system in the UK immediately following the war. In the optimistic spirit of 1945 it was assumed that such successes and precedents would be readily replicable throughout the world and it was assumed that the state alone had the ability to act in the long-term interest of its citizens.

The state, therefore, was the central feature of initial conceptions of international development. National development plans were emphasised as keys to modernisation. Through such plans, the state would create an investment pool by mobilising domestic and foreign savings. Investments would be targeted to industrial expansion and the state would protect infant industries through such import-substitution instruments as tariff and quota policies. The structural transformation required for development would also require the creation of modern workers to work in the modern urban-industrial sector. Unprecedented levels of public investment in education and training would, therefore, be required. In addition, the state would encourage policies and practices to reduce average family size in poor countries to accord more with that of the 'modern/Western family'.

Development was regarded and treated as equal to growth in per capita GNP, and the mainstay of early development economics became the Harrod-Domar formula which treated the rate of growth of per capita income as the independent variable. Gross National Product (GNP) and per capita GNP, themselves products of the Second World War, assumed almost complete exclusivity as the core metrics of development.

This universal treatment of all societies established the early intellectual tradition of international development which essentially held the human condition to be linear, convergent, predictable and manageable, while at the same time dividing the world along a sharp North-South axis. Modernisation was assumed to be inevitable through the application of the model of already-successful industrial states and the every-expanding advances in science and technology. Moreover, modernity would be achieved quickly, since latecomer societies could avoid the long and painful processes that the successful, modern states of the day had been required to follow. In this climate, the United Nations declared the 1960s the 'Development Decade', a ten year period during which it was then claimed backwardness would cease to be a problem as poor countries would move up the continuum to industrialisation and modernity. This vision of universal and easily attainable modernisation for all had a magnetic quality which stimulated international enthusiasm. A new growth industry emerged in the number and variety of international development organisations that were established throughout the 1960s and 1970s.

Faith in this possibility was sustained and reinforced by the economic successes of the early post-war decades. During the period from the late 1940s to the early 1970s, the world economy grew practically everywhere at an unprecedented pace. Jump started by the financial resources of the Marshall Plan, European countries recovered and grew at nearly 5 percent per year. Led by Japan, the economies of Asia registered average growth rates of 6 percent. Brazil doubled its per capita output in an eighteen year period and Latin America as a whole experienced annual growth of 5.3 percent. Africa also grew rapidly at 4.4 percent per year. The two decades from 1950 to 1970 were a period of unparalleled gains in global prosperity. World per capita GDP grew by almost 3 percent annually - more than three times as fast as in 1913-1950. Notwithstanding the expanding cold war that also characterised these years, the period has come to be termed the ***'Golden Age'*** of world economic growth.

Early Voices of Dissent

Even in the Golden Age of the 1960s and 1970s, international development was not without strong detractors and serious critics. The intellectual roots of dissent during this period were essentially Marxist and the mainstream of dissent came to be known as 'dependency theory'. This is most closely associated with Latin America and with the distinguished Argentine economist Raul Prebish during his years as the head of the United Nations Economic Commission for Latin America (CEPAL). The core of the dependency thesis was that Western capitalism, including Western governments, could not be expected to bring about industrial development in poor countries. Poor countries were at the periphery of capitalism and the interests of the centre of capitalism (i.e. the West) were to exploit and preserve this asymmetry in power, production and trade. Especially in Latin America, this line of thinking reinforced import-substitution approaches to national economic management and these proved highly successful, at least initially. There were also, however, more extreme expressions in the school of dependency thought. Andre Gunder Frank, for example, called for the outright rejection of capitalism in all its forms. He and others proposed approaches amounting in various degrees to an autarchic national socialism.

The End of the Golden Age: New Approaches to Development

With the trebling of oil prices in the early 1970s the Golden Age of modernisation came to a sudden and wrenching halt and the world entered what historian Eric Hobsbawm has called the ‘Crisis Decades’. The sharp reductions in economic growth of the early and mid-1970s led to average rates of growth during 1973-1992 that, with the exception of parts of Asia, were substantially below those of the Golden Age. The slowdown was most noticeable in Eastern Europe and Africa, where average rates of per capita GND growth became negative, and in Latin America, where the rate of economic growth barely exceeded that of population increases. The buoyant optimism regarding modernisation and universal development suffered considerable damage and the strong post-war consensus on the inevitability of progress through state capitalism and national planning came under severe and concerted attack.

The initial attack was perhaps most closely associated with a 1972 book, ‘Dissent on Development’ by Peter Bauer. Bauer launched a frontal attack on the foundations of modernisation thought, claiming that it was deeply flawed in that it led to practices that were inherently anti-developmental. He was joined by other economists such as Anne Kruger and Harry Johnson who viewed the state-led development approaches of Keynesianism as discouraging of enterprise and encouraging of rent-seeking behaviours. Throughout the 1970s, a new intellectual architecture of development gradually took hold and was by the late 1970s firmly embedded in the approaches of the major international development organisations. The language of development shifted from an emphasis on national planning, state-led resource mobilisation and industrial targeting to market-friendly policies, macroeconomic fundamentals and responses to the ups and downs of relative prices. In some respects this involved a throw-back to the laissez-faire era of internationalism that had predominated in the years between the two great wars. It drew its inspiration from monetarist and neo-classical economics and from the libertarian philosophy of the minimalist state.

Although by 1980 this school of thought may have become the dominant new orthodoxy of development, a rich and vast array of other concepts and ideas about development and how to promote it also emerged during the same period. In 1969, the distinguished development economist, Dudley Seers, wrote that development and economic growth were not one and the same thing, thereby challenging the hegemony of economics in development thought. His work may be said to have presaged both a lessening of the intellectual preoccupation in development with capitalist growth and the diversification of development thought throughout the 1970s and 1980s into concerns for gender issues, social development and the measurement of social well-being, political and institutional factors, including issues or representation, participation, justice and human rights, and the nature of relationships between local communities and the environment. In a more extreme form, the onset of the Crisis Decades also triggered a complete rejection in some quarters of the idea of international development itself, usually on the grounds that the post-war development effort was a new form of cultural imperialism, involving the attempt to impose particularly inappropriate Western notions of industrial progress and economic growth on others.

The Emergence of More Micro Approaches to Development

A further important shift began to take hold in the 1970s, involving a shift in the balance between micro and macro approaches to development. The motive force behind this - at least initially - derived from rural development studies and is closely associated with names such as Michael Lipton, Amartya Sen and Robert Chambers. Approaches to rural development in the 1950s and 1960s had been based on structural transformation through programmes of land redistribution and on the application of the new technologies of agricultural science that came to be termed the ‘green revolution’. Both approaches were essentially macro in nature, that is to say they were ‘top down’ and afforded little space for the experiences and actions of individuals or for farming households. Poor, smallholder agriculturists, which then made up the considerable majority of the developing country population, were viewed as agents that would respond to price signals or to government actions. It was rare to regard them as individual and rational economic actors, as authors of their own preferences, and possessed of a reservoir of ‘indigenous knowledge essential to their circumstances and their own development.

In this regard, the studies conducted by Lipton and others showed clear evidence that the macro and technocratic approaches of the early modernisation period had disguised a pernicious urban (or anti-rural) bias and that government policies were, in fact, eroding the incentives to poor rural farmers to produce food. A combination of national monopolies through marketing boards and the overvaluation of domestic currencies had produced, in many poorer countries, a punitive level of taxation on ordinary farmers and a transfer from them to urban-industrial interests. The perfectly natural result was the rational response of farmers in the form of a decline in per capita food production. Cambridge University economist-philosopher Amartya Sen was a key figure to the shift in balance from macro to micro. Traditional welfare economics, argued Sen, fell short of an adequate assessment of the social good because its approaches lack essential information about people’s preferences. Thus, he insisted that that development strategies cannot succeed in the absence of careful consideration to local political conditions and possibilities. The work of Robert Chambers gave operational impetus to such thinking through new mechanisms approaching international development via 'participatory methods' which link micro understandings to effective programmes of poverty reduction.

The theoretical and empirical work of people like Lipton, Sen and Chambers provided an important legitimacy to the work of many non-governmental organisations (NGOs) working in international development. It placed them much more centrally as agents of development effectiveness and opened increasing avenues to co-operative and even joint effort between governments, supra-national entities such as the World Bank and the NGOs.

The Brandt Report, Mutuality of Interest and the New International Economic Order

The onset of the Crisis Decades brought to the centre stage the debate about international terms of trade. It was not a new debate. As early as 1950 Hans Singer's paper on the 'Gains and losses from trade and investment in under-developed countries' presented a view that ran counter to economic wisdom that dated from the time of Adam Smith. That implication of the previous wisdom was that an agricultural country need not industrialise to enjoy the fruits of technical progress in manufactures; free play of market forces would distribute the gains from technical progress of the industrial countries to the agricultural countries by turning the terms of trade to the favour of primary products and the primary exporting countries. Singer challenged this, producing evidence that the terms of trade had been moving against agricultural and raw material countries. This was hotly contested by others who questioned the database. The debate on this has continued amongst economists since Singer's early paper.

By the late-1970s, however, there was at least a reasonable consensus that, with the obvious exception of oil, terms of trade for countries dependent on the production of raw materials and commodities had deteriorated and were continuing to do so. Even amongst those who viewed this as a cyclical phenomenon, there was broad agreement that the extreme volatility of commodity prices was inherently destabilising, particularly for developing countries.

Against this background and the dramatic decline in world growth following 1973, the UN General Assembly issued a call in the mid-1970s for a new international economic order (NIEO). In 1980, an independent commission, consisting of twenty diplomats from five continents chaired by former West German Chancellor Willy Brandt produced what came to be called the Brandt Report. It looked to a renewed international Keynesian with the developing world as a crucial marketplace for industrial countries and argued for a world of mutual interest and mutual interdependence. These words may strike one today as somewhat mundane, but at the time they were fresh new concepts of internationalism and of international development. With these concepts in mind, the Brandt Report lent strong support to the NIEO call of the UN and specifically recommended the establishment of a new international commodity price stabilisation fund and other changes to the structures of world governance. The Report drew attention to the fact that the 1945 vision for the post-war international order, in addition to the IMF and the World Bank, had included an International Trade Organisation (ITO) with a primary function of stabilising commodity prices. At the time, the IT was fully negotiated but it was not agreed to and it failed to come into existence. Neither GATT (General Agreement on Trade and Tariffs) nor the newly-created (1995) World Trade Organisation (WTO) has anything to do with commodity stabilisation.

Conferences and negotiations followed, but no agreement. Among northern governments, the United States was the most vocal in arguing against major changes in international economic institutions on the grounds that these would not be in the interests of the United States and would, in any event, be of very little benefit to poorer countries.

From Development to Undevelopment

In 1982, Mexico announced that it could not service its short-term international debt. Other countries followed and the world was plunged suddenly into a debt crisis that threatened the international financial system. The focus of international development became riveted on a new set of problems with the core of that focus on measures of macroeconomic stabilisation, debt management and the avoiding of a global financial collapse.

What began as a liquidity problem quickly became a widespread financial crisis and then a more generalised socio-economic crisis. In advanced economies both unemployment and social discontent increased significantly. The reversal of socio-economic gains of the previous twenty-five years made the 1980s a 'Lost Decade' for most developing regions, with the notable exception of Southeast Asia. The major upheavals experienced by the Soviet Union and Eastern Europe during the second half of the 1980s and the early 1990s led to precipitous declines in living standards in these countries, while in Western Europe the economic recovery of the early 1990s did not manage to reduce unemployment rates. Following a prolonged period of economic stagnation in the early 1990s, Japan was seriously affected by the collapse of East Asian currencies and stock markets in 1997. Income inequalities worsened everywhere (again, with the exception of some East Asian countries), and for the first time since the Great Depression, poor and homeless people became highly visible in many cities of advanced industrial nations. The concept of 'social exclusion' emerged, first in France and later in the European Union, to account for the re-emergence of social problems that were thought to have been solved decades earlier.

The Era of Structural Adjustment

The onset of the debt crisis reinforced neo-liberal and supply-side economic thought as the ruling dimension in international development and to discredit the modernisation efforts of earlier decades. Serious marcoeconomic imbalances, usually in the form of seriously overvalued exchange rates and in large fiscal and current account deficits, had long been evident in the economies of much of Latin America and Africa. Few serious thinkers in the early 1980s doubted the importance of action to bring about much greater stabilisation. The policies and practices required to being about such stabilisation are widely known as 'structural adjustment'.

Structural adjustment was hardly a new concept. The essence of all development involves structural adjustment whether from rural to urban or from subsistence production and barter to industrial production and a formal economy. The structural adjustment that became the bedrock of development practice in the 1980s and 1990s was, however, more specific and involved two defining characteristics. The first characteristic involved measures to stabilize economies. Macroeconomic imbalances in most developing countries were, at least in considerable measure, the result of a pattern of fiscal spending that consistently exceeded fiscal revenues, of overvalued exchange rates and of rather loose monetary policies. The second characteristic, liberalization, had a much more ideological character and was predicated on libertarian thought, emphasizing economic openness, the dismantling of the policies of import-substitution, the removal of all barriers to trade, investment and ownership, the privatization of public assets and the minimalist state.

In the fifty-year history of modern international development there are probably no two words that have generated more passionate debate, more polarized visions and more unsubstantiated claims that the words 'structural adjustment'. To its supporters, these words conjured up visions of a paradise of perfect competition and of efficiency gains that would generate vastly increased wealth and would prove the thesis that a rising tide raises all boats. To its detractors, structural adjustment was nothing short of a perfidious Darwinism, and its effects would be seen in vastly increased inequalities and in an explosion of human misery and environmental destruction. The IMF and the World Bank were usually credited with the first position and a broad range of NGOs with the latter. The divide on this issue between the institutions of international development were not matters of detail, interpretation or of approaches to a common objective. They were profoundly ideological, with each side choosing selectively from the evidence to support the credo it had adopted. Far more so than the ideological divide of the Cold War, structural adjustment had shattered the post-war consensus on modernization as a central pillar to the new internationalism.

By the 1990s, improved studies and greater evidence provided a very complex and mixed picture of developmental consequences of structural adjustment. At the macro level, world trade grew markedly. The total value of all imports and exports by 1994 was more than twice that of 1980. Liberalization was integrating the global economy and the word '***globalization***' had become part of every-day vocabulary. Moreover, the rate of growth of world trade exceeded that of growth of world production: in 1994, for example, world merchandise trade grew 9.2 percent, more than three times faster than world Gross Domestic Product. Structural adjustment was changing the structure of the global economy! At the same time, however, the evidence was unequivocal that the terms of trade had shifted against primary commodities (exported primarily by developing countries) and in favor of high technology services and manufactured products (typically industrialized nations' exports). Vast new wealth had been generated, but it was also highly concentrated. In almost all countries income distribution had experienced serious deterioration. The rising tide was quite clearly not raising all boats.

Thus, there is much evidence that supports the claims of the enthusiasts for structural adjustment and globalization. There is also, however, much evidence that supports those who vilify it. The fierce competition that has resulted from globalization has contributed to increases in impoverishment, inequalities and work insecurity. There has also been a weakening of social-support systems and of the institutions providing them. Liberalization has reduced agricultural protection and raised the price of food, with resulting difficulties for food importing countries. International competition for markets and jobs has forced many governments to reduce taxation and to cut public services on which the poor are especially dependent.

Faced with this evidence, by the mid 1990s, development theory was moving, albeit slowly, to a new synthesis on structural adjustment. Much sharper distinctions had emerged between the stabilization and the liberalization components of adjustment. All sides of the development spectrum had reached broad agreement that development does not occur without macroeconomic stability and that the poor pay a disproportionate price for its absence. Major differences on liberalization have continued, but new directions in development economics are emerging that recognize increasingly the limits of markets and there is a growing acceptance that, given imperfect information and incomplete markets, government intervention can produce an allocation of resources that will make some better off without making others any worse off. In its World Development Report of 1997, the World Bank stated explicitly that its previous insistence on the minimalist state as part of liberalization had been misguided, that policy must reflect the fact that that markets do not emerge on their own and that strong and interventionist governments are preconditions to development.

Environment and Development: From Economic Interdependence to Ecological Interdependence

Since 1972 and the publication of the Club of Rome's report 'Limits to Growth', environment has assumed an increasingly important position in the theory and practice of international development. In that same year, the Stockholm Conference on the Human Environment was held. In 1987 an independent commission, headed by then Prime Minister of Norway, Gro Harland Brundtland, presented its report 'Our Common Future' to the Secretary-General of the UN. Five years later, in 1972, world leaders gathered in Rio de Janeiro for the 'Earth Summit', the largest international conference ever held.

These were only the largest and most visible of the landmarks that have advanced environmental concerns ever more deeply into international development discourse. In addition, a large number of new international institutions sprang up, such as the Global Environmental Facility, International Union for the Conservation of Nature, Development Alternatives and the Earth Council, to name just a few.

Among the many complex factors, considerations and fears that served as the motive force for these developments was the nature of the link between the physical environment and gains in human welfare. The facts speak for themselves. Since 1900, the world's population has multiplied more than three times and the global economy increased twentyfold. The consumption of fossil fuels has grown by a factor of 30 and industrial production by a factor of 50. Most of that growth, about four-fifths of it, occurred since 1950 and most of that has been concentrated in the North where some 20 percent of the world's population consume about 80 percent of the world's goods.

The term 'sustainable development' was a product of the Brundtland Commission and was an attempt to confront and resolve two realities: the need for continuing economic growth in order to improve the condition of the majority of humanity and the need to prevent that growth from exceeding the resource and sink limits of the earth. Brundtland, a politician herself, was fully aware that political realism ruled out calls for income redistribution or suggestions for limits to the economic growth aspirations of poor countries. Her call, therefore, was to expand the global economy by a factor of up to ten in order to alleviate poverty world-wide and to do so 'without growth in throughput beyond environmental carrying capacity'. This is the essence of the recent concept of sustainable development.

This call for sustainable development has elicited two opposing reactions. The first is to define sustainable development as 'growth as usual' but at a slower pace, a formulation forcibly rejected by developing countries as consigning them to continuing poverty. The second is to define sustainable development as ‘development without growth in throughput beyond environmental carrying capacity’. This is a more generally acceptable formulation, but it raises an immediate dilemma about whether it is consistent with economic aspirations for the elimination of poverty.

Economist Herman E. Daly attempted to address this dilemma in his **impossibility theorem** which holds that the entire world’s population simply could not enjoy U.S. consumption levels. He illustrated this with reference to the fact that humans use of destroy about 25 percent of the earth’s net primary productivity (NPP), defined as the total amount of solar energy converted into biochemical energy through the photosynthesis of plants minus the energy these plants use for their own life. At a 1.6 percent yearly population growth, population and humankind’s share of NPP would double in 43 years. A further doubling would place humanity’s share of NPP at 100 percent, which is not possible. In fact, Daly concluded that humankind’s share of NPP was already unsustainable in 1991. The solution he proposed was to shift the basic elements of economic thought from an emphasis on technologies that increase the productivity of labor and manmade capital to those that increase the productivity of natural capital. This would occur by market forces if the price of natural capital were to rise as it became more scarce.

A great deal of serious work and thinking about sustainable development is underway and needs to be followed closely. Advances in new measurements that harmonize economic and environmental indicators are shifting development economics towards the 'internalizing of externalities' (i.e. including environmental and social factors as internal to economic models rather than as factors that are external to such models and dealt with as such). The United Nations is working the index of sustainable economic welfare (ISEW), a methodology incorporating resource depletion and environmental degradation into gross product statistics. When this becomes available, it could have profound effects on how we perceive and measure human progress. To illustrate, a recent study by R. Repetto and colleagues at the World Resources Institute examined the implications for Indonesia of a more accurate measure of income on wealth. They calculated that when you considered the depletion of only three natural resources - forests, soils and petroleum - the average annual growth of Indonesia's GDP per capita from 1971 to 1984 fell from 4.8 per cent to only 1.7 percent. If coal, mineral ores, and other non-renewable resource exploitation and fisheries deterioration were included, average GDP would have fallen even more.

Although the integration of environment into development and the idea of sustainable development have become defining features in the current trajectory of international development, there are many detractors. Some are scornful of the concept of sustainable development itself and refer to it as an oxymoron. Others assign faith to future technological advances that will allow unlimited economic and consumption growth without compromise to environmental carrying capacity. In general, developing countries are exceedingly wary of any measures originating in the North that might place limits on their options for economic growth. These factors and disputes will doubtless remain central to the shape and evolution of international development in the next century.

The Asian Tigers

Throughout almost all of the turmoil following the end of the Golden Age, including the development reversals and the 'lost decade' of the 1980s, a number of states of Southeast Asia prospered continuously and to an extent that was without historical precedent. Singapore, South Korea, Taiwan and, more latterly, China, Malaysia, Thailand, Philippines and Indonesia demonstrated both rates of annual economic growth and indicators of poverty reduction that became the envy of the entire world. Starting in mid-1997, this remarkable development success story came apart at the seams. For development thinkers and international development organisations, East Asia had provided incontestable proof that development could happen, that poverty and misery could be conquered. For well over a decade, poor countries and development organisations alike turned to East Asia for inspiration, while scholars and policy analysts focused their attention on the area. In 1993 , the World Bank produced its study of the situation under the title 'The East Asian Miracle'.

Then, over a period of just twelve weeks in late 1997, the currencies and stock markets throughout the region lost nearly half their value. The East Asian Miracle became the East Asian Crash. In addition to the multiple accusations and counter-accusations, pious dicta and expressions of rage that followed, two vastly differing intellectual interpretations emerged of the East Asian development model itself. Not surprisingly, these reflected prior development debates on liberalisation and structural adjustment. The first interpretation has been termed the neo-liberal interpretation and it argued that the Asian development model had rested on a fatally flawed state capitalism, making the collapse that occurred simply overdue and inevitable. In its extreme form, this interpretation trumpeted the global death throes of state capitalism.

The rival interpretation held that the Asian development model was fundamentally sound and that the crisis was due not to over-regulated and insulated economies but rather to domestic under-regulation and of the absence of strong state mechanisms to moderate market excesses. That this view was perhaps most closely associated with Joseph Stiglitz, Chief Economist at the World Bank, indicated how far the Bank's own position and thinking had shifted on structural adjustment and liberalisation.

Whatever the disagreements over what caused the East Asian meltdown, most development analysts were agreed on one thing: it may or may not be true that openness to the international economy produces major development gains, but it is most certainly true that openness leaves countries vulnerable to external shocks. Shocks are part of the global landscape and developing countries have experienced a large number of these since the 1970s: rapid changes in the terms of trade, reversals in capital flows and inflationary and interest rate surges in world interest rates. The conclusion is clearly that, if international economic openness is to work for developing countries, the policies, institutions and human talent to manage turbulence in the world economy are critical.

The East Asian meltdown came with suddenness and virulence and it shattered - at least temporarily - the most impressive development success story of the past half century. This has had major effects on all of development, especially as East Asia had been the exception to the turmoil and setbacks experienced by developing countries from 1973 onwards. To a considerable extent, East Asia had become the model and the template that poorer, aspiring countries had hoped to follow. The obvious development questions became what model can/ought poorer countries now to follow and could the rapid movement out of poverty and misery that East Asia had accomplished ever again be duplicated. There has been a deep and sobering reflection on such fundamental questions since the implosion of the Asian miracle. There has also been a good deal of serious re-examination of the basis of the miracle itself.

This has been illuminating. Most previous interpretations of the successes in East Asia had emphasised the importance of domestic factors, in particular establishing the 'right' domestic policies and conditions conducive to international investment and to 'export-led growth'. There were, however, a selected number of more critical assessments. Robert Wade, for example, had shown that a good part of the reason for East Asian success had to do with international factors. In the 1960s, international factors had combined to produce a special set of factors relatively favourable to areas of low-cost industrial production, including access to industrial country markets, greatly increased access to international finance, and increasing relocation of production by multilateral corporations to lower-wage countries. The countries that were able to seize these opportunities were generally those which had already established an industrial base through previous policies of import-substitution, had invested heavily in basic education and which also had determined governments committed to the strong management of an industrialisation process by the state. The recent re-examination of the miracle is lending much increased credence to this assessment.

The point, of course, is not to diminish the importance of sound internal policies and management, but to draw attention to the fact that external factors were and are of great importance in the successes of states like Korea and Taiwan. The external factors that exist today are vastly different from those that applied in the 1960s when the East Asian 'tigers' penetrated western markets. There has been a dramatic fall in the demand for unskilled labour and raw materials per unit of industrial production. Tariff barriers may be falling, but quantitative barriers (non-tariff) have increase with special discrimination against developing countries.

It seems reasonably clear, if depressingly so, that East Asia's miracle will not easily be replicated by poorer countries in future development efforts.

International Development on the Eve of the Millennium

Considering the rich array of concepts, ideas and experiments that have characterised international development as a major component of the new internationalism that emerged from the ruins of the second world war, what has been the result of fifty years of attempts to promote development? Not surprisingly, the development efforts of five decades have been neither a great success not a dismal failure. On the positive side, a handful of low -income countries have achieved in one generation standards of living approximating those of the successful, industrialised nations. Life expectancy has doubled in many countries and increased in all. Educational levels have similarly increased in all developing countries. More people have moved out of poverty during the past half century than in the previous one thousand years. Income per capita has doubled in countries such as Turkey, South Korea and China in less than a third the time it took to do so for the United Kingdom and the United States a century or so earlier.

On the negative side, the absolute number of poor people in the world has increased. Income disparities between rich and poor nations, and between the rich and poor in both developed and developing countries, have become far more pronounced. The environment has been subjected to extreme and dangerous stress in the name of development. Social demands have grown by quantum factors throughout the developing world.

The balance sheet is a complex amalgam which will fully be assessed only with the luxury of a future historical retrospective. What is clear on the eve of a new millennium is that the context for future development efforts has become more complex and uncertain than in its first half century. The development experiment was anchored in the political order of the cold war which disappeared as we entered the 1990s. This has been replaced by the uncertainties accompanying a transition to a new, more complex and less predictable world order. At the level of society and culture, the penetration of scientific and technological advances is overturning time-honoured assumptions that, for countless previous millennia, have underpinned local social orders in many parts of the world. The pace and impact of scientific advances and technological innovations are unprecedented with the result that those with the capacity to absorb, use, and adapt the advances in science and technology will be better placed not only to enrich themselves but also to influence the conduct and evolution of human affairs. Those unable to harness these advances will almost certainly be increasingly marginalized. The old geographic boundaries separating rich and poor are becoming increasing meaningless. The assumption of a North-South axis which defines wealth and poverty is firmly imbedded in institutional approaches to development and in the public mind. It fails, however, to reflect the new reality of increasing concentrations of individual wealth in countries generally regarded as poor, and vice versa. The fault line between rich and poor has become a near-impenetrable patchwork that cuts profoundly within individual societies and which is making increasingly meaningless the aggregate statistics and concepts which are used to understand development.

The international development experiment that was launched as integral to the new internationalism at the close of the Second World War of this century has proved in the end to be integral with the human condition. As the human condition changes, so does our understanding of development. Its future - as its past- will depend on how fast it learns from its mistakes and from its successes.

ANNEX D

A fractured global order[46]

As we enter into the 21st century there is an accelerated, segmented and uneven process of globalization presently under way. The worldwide expansion of productive and service activities, the growth of international trade, the diminishing importance of national frontiers, and the intensive exchange of information and knowledge throughout the world, all coexist with the concentration of ‘global’ activities in certain countries, regions and even neighborhoods, as well as within certain firms and corporations. Table D-1 in the main text presents a list of the main changes and trends prevailing in the international context at present.

The simultaneous integration and exclusion of countries - and of peoples within countries - are two intertwined aspects of the multidimensional processes of globalization and fragmentation under way in our turbulent period of history, a time that is witnessing the emergence of a *fractured global order*. This is an order that is global but not integrated; an order that puts all of us in contact with one another, but simultaneously maintains deep fissures between different groups of countries and between peoples within countries; an order that is benefiting a small percentage of humanity and segregating a large portion of the world’s population.

The structure of the fractured global order can be conceptualized in terms of three closely interconnected and partially overlapping domains, each of which has its own specific features and ways of interacting with the other two. These are: the domain of the global, the domain of the networks, and the domain of the local (Figure D-1).

The *domain of the global* consists primarily of the intensive, dense and nearly instantaneous exchanges of symbols and intangible goods on a planetary scale, which are characteristic of the information age. Advances in communications and information technologies have allowed us to free our activities and interactions from the constraints imposed by our immediate and concrete experiences of time and space, and to restructure those activities and interactions almost at will in the abstract domain of the global. The separation and delinking of time and space from each other, and from their concrete experiential settings, are what make possible the domain of the global. Social relations are thus disembedded or lifted out from their local contexts, transformed into vast and complex symbolic arrays that represent myriad social interactions, and projected into the realm of the global where they become free to roam and intermingle in a rather fluid fashion.

Images, sounds and words that blanket the planet and quickly reach almost everywhere through mass media; cultural products and icons - music, movies, television programs, sports and fashion, ideas and concepts, and even aspirations and values - that link societies far apart from and virtually unknown to each other; and the enormous exchange of messages, data and information through telecommunication networks and the Internet - all of these are the stuff from which the domain of the global is made. In this domain, it is rather difficult to trace the paths followed by specific transaction, for interactions take place at high speeds, are rather ephemeral, and can involve many agents simultaneously. The

[46] Extracted and adapted from Francisco Sagasti, *Development Cooperation in a Fractured Global Order: an Arduous Transition*, Ottawa, International Development Research Centre, (FOCUS series), 1999.

communications networks that sustain the domain of the global now allow human beings to converse with each other in a variety of many-to-one, one-to-many, and many-to-many patterns, something that was not possible until just a few years ago.

The *domain of the networks* consists of a bewildering multiplicity of combinations of exchanges of tangible and intangible goods - trade in products and services, power and influence relations, transfers of data and information - which flow through a myriad of identifiable channels and nodes that interconnect social groups all over the world. Interactions in the domain of the networks involve all kinds of organizations - public institutions, private corporations and civil society associations -, whose interrelations create a tangled web of overlapping and intertwined networks of networks. The domain of the networks is constantly transforming itself, as connections between its constituent units are established and severed, new channels and nodes are created and old ones destroyed, and as the network units mutate and evolve.

TABLE D-2

Summary of the main features of the emerging fractured global order

International Security in a post-bipolar world

- End of the Cold World and demise of East-West rivalry.
- Virtual elimination of the threat of an all-out nuclear war and of conflicts based on Cold War ideology.
- Emergence of new security concerns: environmental conflicts, terrorism, drug traffic, international crime syndicates, proliferation of chemical and biological weapons, proliferation of small-scale nuclear devices.
- Erosion of the power of nation states as political units (both from below and from above).
- Increase in number and intensity of regional conflicts (ethnic, religious, over resources).
- Larger role for international and regional institutions, particularly the United Nations, in maintaining security.

Economic and financial interdependence

- Rapid growth and globalization of financial markets.
- Changes in trade patterns: shift of the content of trade in favor of high technology services and manufactured products, emergence of the North Pacific as the largest trading area, multiplication of regional trade agreements, growth of intra-firm trade, creation of the World Trade Organization.
- New situations in key countries (United States, Russian Federation, Japan, European Union, China, East Asian newly industrialized countries).

Persistent inequalities and economic uncertainty

- Persistent and growing disparities between industrialized and developing countries.
- Growing inequalities of income and opportunities within both rich and poor countries.
- Greater instability of the international economic system.
- Increasing concern and demands for better international economic governance.

Social conditions

- Demographic imbalances (low growth and aging in rich countries vs. relatively high population growth in developing countries).
- Growing social demands (food, education, health, housing, sanitation) in poor countries.
- Unemployment: developing countries face the challenge of raising labor productivity while absorbing the growing number of entrants in the labor force; developed countries face structural changes in employment patterns and an aging work force.
- Widespread and growing social exclusion (gender, ethnic, age, poverty, education) in both developed and developing countries.

Environmental sustainability

- Greater awareness of the problems of resource depletion.
- Threats to environmental sustainability and appropriate resource use: poverty in developing countries; wasteful consumption in rich nations.
- Security also defined in environmental terms.
- Need for and development of environmentally sound technologies
- Acknowledgement of danger posed by global environment problems.

Culture, religion and ethical concerns

- Growing importance of religious and spiritual values.
- Rise of religious fundamentalism (Islamic, Christian, Hindu, etc.) as a driving force of economic, social and political actions.
- Conflict between cultural homogeneity and cultural identity as a result of globalization of mass media, communications and transportation.
- Growing importance of moral and ethical issues in equity and human rights issues.

Governance and spread of democratic practices

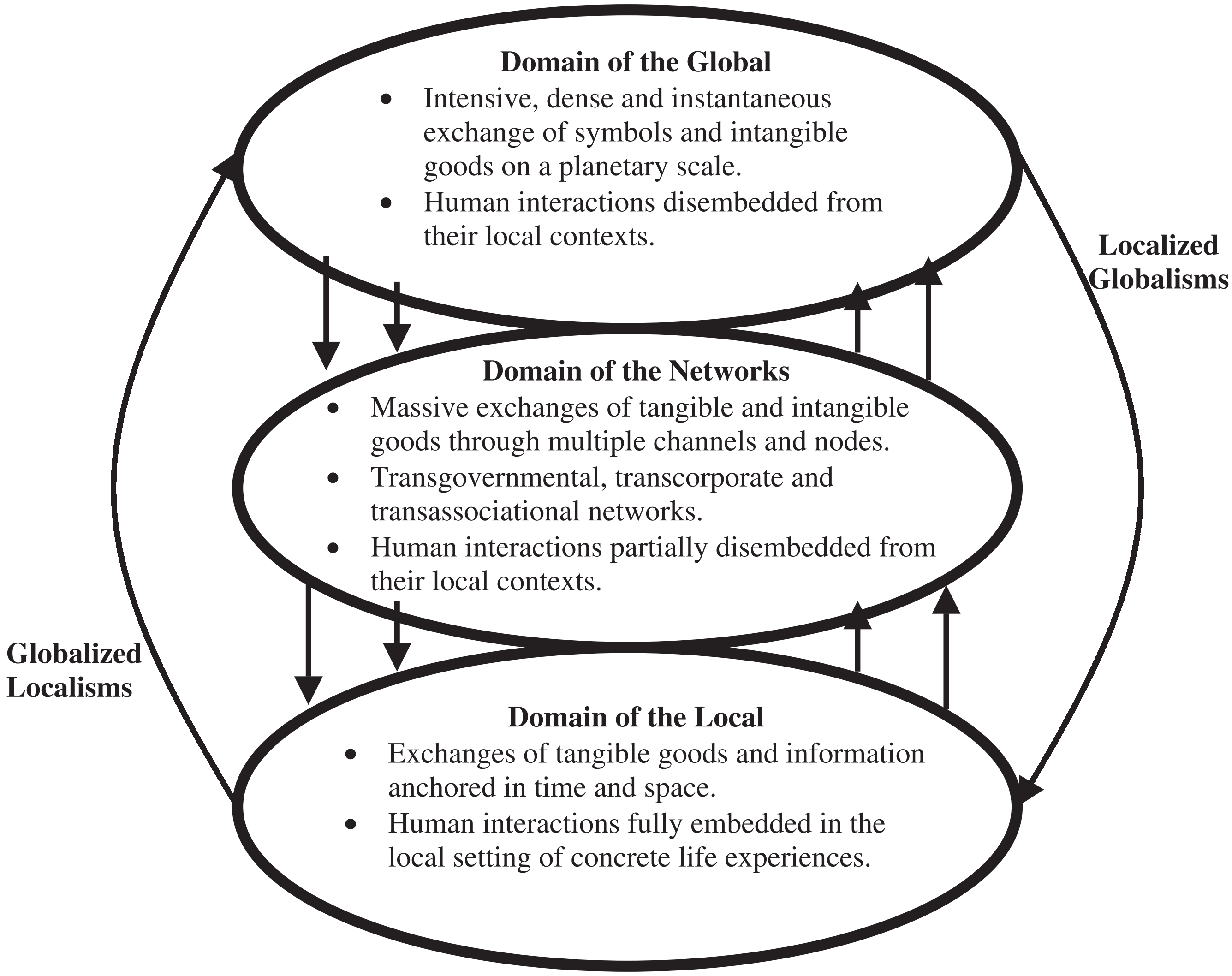
- Crisis of governance in high-income and poor nations (e.g. representation vs. efficiency, social demands exceed institutional capabilities).
- Political pluralism, democracy and popular participation have spread throughout most world regions.
- Rise of ‘authoritarian’ or ‘illiberal’ democracies in several regions.
- Redefinition everywhere of the roles of the public sector, of the private sector and of civil society organizations.
- Governance problems exacerbated by the social impact of economic policy reforms.
- Information technology having major impact on political systems and governance.
- Growing importance of social capital and of institutional development.

Knowledge explosion and knowledge divide

- Exponential growth of knowledge.
- Greater importance of knowledge as a factor of production; emergence of the ‘knowledge society’.
- Changes in the conduct of scientific research: increasing costs, greater specialization, importance of information technology.
- Increasingly systemic character of technological innovation: more and greater diversity of inputs required; more actors involved.
- Change of techno-economic paradigm: from energy intensive (key factor: oil) to information intensive (key factor: microchip).
- Transformation of production and service activities by major advances in communications and information technology, biotechnology and materials technology.
- Extreme and cumulative inequalities in science and technology capabilities between industrialized and developing countries.
- Limited science and technology capacity of developing countries to face economic, social, political, cultural, environmental and knowledge challenges.

FIGURE D-1

The Three Domains of the Fractured Global Order



Transgovernmental, transcorporate and transassociational networks, together with the thick sets of relations between them, are the main types of structural arrangements found in the domain of the networks. As the hold of nation states on international affairs has weakened during the last three decades, a host of new cross-border linkages between public agencies has emerged in full view. These *transgovernmental networks* involve regulatory agencies, executives, courts, armed forces and legislatures which now routinely exchange information and coordinate their activities (Anne-Marie Slaughter, 'The real new world order', *Foreign Affairs*, Vol. 76, No. 5, September-October 1997, pp. 183-197). *Transcorporate networks,* comprising multinational enterprises and private firms operating at the international level through wholly-owned subsidiaries, foreign partners, representatives and agencies, together with strategic alliances of all types, have long been an established feature of the international economic scene. In addition, a variety of civil society organizations - ranging from citizens groups and professional associations to environmental and human rights activists - have now formed regional and worldwide alliances, thus configuring a new set of *transassociational networks* whose international weight has increased considerably. While states will continue to be the main unit for political decision making in the fractured global order, the erosion of sovereignty is making them more porous and allowing transgovernmental, transcorporate and transassociational relations to proceed in an increasingly decentralized manner.

The social relations reflected in the combinations of tangible and intangible goods exchanged in the domain of the networks are both partially embedded in, and partially disembedded from, the time- and space-bound local contexts of interaction. Long in the making, the domain of the networks owes its present richness to the technological innovations in transport and communications of the last five decades, which have facilitated new and more intensive few-to-many, few-to-few, and few-to-one, as well as one-to-few and many-to-few, patterns of interrelation and communication between human beings.

The *domain of the local* is constituted by those relations and transactions that are anchored in time and space, and which comprise primarily the production, exchange and consumption of tangible goods and services, together with the corresponding information resources and personal interrelations, that are necessary for human beings and social groups to exist and evolve. This domain has been in existence since the dawn of humanity, and the social relations reflected in the transactions and interactions that comprise it are firmly embedded in the settings of our concrete living experiences.

In the domain of the local, where most of our daily lives unfolds, transactions are relatively easy to trace and the prevailing patterns of interrelation and communication between human beings one-to-few, few-to-one and few-to-few exchanges. This domain contains the extraordinarily rich range of face to face interactions between individuals that allows us to convey to each other, not only information about things, but also feelings, emotions, aspirations and values, all of which are at the root of what constitutes to be human and confer human beings their unique character.

As these three domains overlap, it is possible to identify social interactions located in the interfaces between them. For example, financial transactions which take place on a global scale, as well as money that never rests and moves constantly throughout the world's financial channels and hubs, straddle the domains of the global and of the network. Point to point trade in goods and services taking place through clearly identifiable routes, and which initially requires localized production and ultimately involves localized consumption, spans both the domains of the local and of the networks.

In addition, some activities circumscribed in time and space can rise from the domain of the local, processed and leveraged through the domain of the network, and reach the domain of the global (e.g. American English as the Internet language, tastes for Chinese food and Brazilian music, Western market economy concepts and policies typified in the so-called 'Washington Consensus', designs derived from local cultures from developing regions). The reverse happens more frequently, for interactions that take place in the domain of the global filter down through the domain of the networks and reach the domain of the local (e.g. the tourist and travel industries focusing on countries and regions with rich historical heritages, the technique of music videos used to present local compositions and talent, highly mobile financial assets invested in medium and long term projects in a specific location). Boaventura de Sousa Santos (*Toward a New Common Sense,* New York, Routledge, 1995, p. 263) calls the former 'globalized localisms', and the later 'localized globalisms', and points out that in the context of a highly asymmetric fractured global order, the rich or 'core' countries specialize in globalized localisms, while the poor or 'peripheral' countries are left primarily with localized globalisms.

In economic terms, the domain of the local comprises what are known as non-tradable goods, such as personal services, retailing, local transportation and heavy goods with high transport costs; the domain of the network comprises all types of tradable goods, services and information that can be transported and exchanged over relatively long distances; and the domain of the global includes what may be called hyper-tradable goods and non-personal services, which can be sold, bought and transferred in a nearly instantaneous fashion all over the world, many of which (currency trading, for example) are exchanged at a frenetic pace.

The emerging fractured global order and its three domains are characterized by a multiplicity of fault lines of political, economic, social, environmental, cultural, scientific and technological nature; these faults overlap partially and often shift direction; they sometimes reinforce each other and at other times work at cross purposes. The overall picture they paint is one of turbulence and uncertainty in which a variety of contradictory processes open up a wide range of opportunities and threats that defy established habits of thought. Integration and exclusion coexist uneasily side by side in all domains and aspects of the fractured global order. All of this is certainly in line with what characterizes periods of profound and fundamental transformations, as was the Renaissance, and as is the transition we now embarked in towards a post-Baconian age (Francisco Sagasti, *The twilight of the Baconian age*, working paper, Lima FORO Nacional/Internacional, 1997).

It has been argued that the fractured global order has long been in the making, and that the fractures that accompany the globalization process emerged as far back as the 16th century, with the first wave of Western European capitalist expansion. There is ample merit in tracing the historical roots of the fractured global order over several centuries - most notably to balance the lack of historical awareness of some analysts who view it as a relatively recent phenomenon.

Yet, while fully acknowledging the importance of a centuries-old perspective of globalization, we would argue that the processes of accelerated political, economic, social, environmental, cultural, scientific and technological change that have unfolded since World War II - and which have rapidly acquired a planetary character - are creating a new setting for the evolution of interactions among the world's peoples. In contrast with previous bursts of globalized exchanges, all of which took place within the framework of the Baconian program, the emerging fractured global order is deeply embedded in the transition process to a post-Baconian age and is also affecting in a major way the character of this transition. Among other things, such transition demands a reinterpretation of what we mean by progress and development, particularly in view of the fundamental changes that are taking place in our conceptions of the human condition.

The multiplicity of processes that are giving birth to a fractured global order are characterized by ambiguities, contradictions and inconsistencies, all of which are generating widespread confusion and uncertainty. It is necessary to dispel the notion that the variety of forces at play in the three domains of the fractured global order are all pointing in one general direction, whether positive or negative. Each and every one of these forces, and any combination of them, can produce 'good' and 'bad' results depending, among other things, on the perspective from which they are viewed, the structure of power relations in those domains and aspects of the fractured global order under consideration, and on the capacity of developing countries and regions to design and carry out strategies for overcoming their disadvantages.

In all of the cases of transforming perceived 'bads' into 'goods' within the framework of the fractured global order, the capacity to view a situation from a perspective that highlights opportunities, together with the ability to design and put in practice strategies to take advantage of such opportunities, become a critical asset for those who wish to revert the apparently unfavorable consequences of globalization. A major adjustment of mindsets will be required to fully exploit the room for maneuver offered by the turbulent context of the emerging fractured global order. For example, many dichotomies that were deeply embedded in our habits of thought until recently - competition vs. collaboration, market forces vs. state intervention, democracy vs. authoritarian rule, global actions vs. local solutions - are losing their sharp edges as contradictory forces appear to converge and reinforce each other at specific times and places. Corporations that compete fiercely in some markets form strategic alliances in others, government guidance and regulation are required to make markets work effectively, authoritarian rule coexists with free elections and a free press, and 'think globally, act locally' solutions are now part of mainstream thinking and policy making, especially in environmental matters.

Hans-Henrik Holm and Georg Sorensen (*Whose world order?: Uneven globalization and the end of the Cold War*, Boulder, Co., Westview Press, 1995, p. 6) have suggested that 'uneven globalization is best conceived as a dialectical process, stimulating integration as well as fragmentation, universalism as well as particularism, and cultural differentiation as well as globalization'. Yet rather than a *dialectical process*, in which one thesis and its antithesis lead to a synthesis which is then transformed into a new thesis, the multiplicity of trends that conform the fractured global order could be better characterized as a *set of paradoxical processes*, in which mutually inconsistent and contradictory trends coexist without prospects of resolution, at least in the near future. Changing circumstances may even turn these contradictions into convergences and coincidences. Moreover, the unexpected turn that events may take in a turbulent environment suggest that those social actors that would not have the capacity to exert influence in a more stable context may have the possibility of shaping the nature of the outcomes of the multiplicity of processes that are now unfolding in the world scene.

The conceptual framework of the fractured global order does not postulate the existence of an overall coordinator that decides on the course of the contradictory processes of globalization and fragmentation, let alone of a conspiracy to run the world so as to exploit and debase the majority of the world's population that are negatively affected by them. As has been the case throughout history, nobody is 'in charge' of the turbulent processes that are creating a few winners and many losers. The various interconnected systems that make up the three domains of the fractured global order run according to their own logic, and those of the interactions between them. While this is no consolation to those who experience the anxieties and the pain associated with the transition to a new world situation, it suggests that the first task to confront the threats of the fractured global order, and to take advantage of the possibilities it offers, is to understand the multiple driving forces of its various domains and components, their changing nature, and the logic that animates them. Only then it will be possible to design strategies and policies to improve the condition of the excluded and marginalized.

Nevertheless, the inexistence of a *deus ex machina* to control the processes leading to the fractured global order does not mean they lack an overall direction. This direction emerges from the prevailing pro-market and anti-state way of thinking in the late 20th century. It is leading, albeit in jagged and paradoxical manner, towards both greater integration and fragmentation in all realms of human activity. Moreover, those who benefit from such state of affairs (primarily private firms and individuals associated with highly mobile capital and knowledge resources), exert a dominant influence in the world's centers of political power. They also appear determined to thwart any efforts to slow the pace of globalization, and even to reflect on where are we now and to explore whether the emerging fractured global order is where we want to be.

The processes leading to the emergence the fractured global order can be appropriately characterized using the metaphor of the 'juggernaut' that Anthony Giddens used to describe the process of modernization:

> "...- a runaway engine of enormous power which, collectively as human beings, we can drive to some extent, but which also threatens to rush out of control and which could render itself asunder. The juggernaut crushes those who resist it, and while it sometimes seems to have a steady path, there are times when it veers away erratically in directions we cannot foresee. The ride is by no means wholly unpleasant or unrewarding; it can often be exhilarating and charged with hopeful anticipation. But so long as the institutions of modernity endure [we would substitute 'fractured global order' for 'institutions of modernity'], we shall never be able to control completely either the path or the pace of the journey. In turn, we shall never be able to feel entirely secure, because the terrain across which it runs is fraught with risks of high consequence." (Anthony Giddens, *The Consequences of Modernity*, Cambridge, Polity Press,1990, p. 139).

The main responsibility for finding ways of improving the living conditions of the developing countries and regions that have, so far, not benefited from (and even harmed by) the trends that are giving shape to the globalization juggernaut, lies squarely on the shoulders of the leaders in these countries and regions. But they cannot do that by railing against the forces that are shaping the fractured global order; the real choice is not how best to fight globalization, but rather how to govern and manage it. Perhaps the juggernaut metaphor should give way to the metaphor of the surfer who rides huge waves and safely reaches the shore. He cannot control the complex and powerful movements of the waves, but nevertheless is able to guide his surfboard to take advantage of the slightest changes in the direction of the sea currents and the winds. The surfer may even be allowed to hold the illusion that he is 'steering' the waves to make them reach the shore.

However, even the most determined and well-designed efforts will yield no results if the international context remains heavily biased against them. Thus, the international communities of nations, corporations and civil society associations have a most important role to play in removing constraints and creating favorable conditions for those who embark in the uncertain road towards development, whatever meaning we may eventually give this word as we move into a new century and into the post Baconian age.

Perhaps the most important challenge faced by the international community in the transition to the 21st century is to prevent the multiplicity of fractures that span all the domains of the emerging global order from creating self-contained, partially isolated pockets of mutually distrustful peoples, ignorant and suspicious of the viewpoints, aspirations, potentials and capabilities of each other. It is essential to prevent these fractures from creating inward-looking societies - both between and within rich and poor nations - that relate to one another only through symbolic links forged by mass media or through narrowly circumscribed economic transactions, and that interact in ways that are fraught with conflicts that may threat human and environmental security.

Development cooperation institutions, and the Multilateral Development Banks in particular, work primarily to in the domain of the networks, and its main task is to help to bridge the fractures that are emerging and are deepening in the global order. The rise of transgovernmental, transcorporate, and transassociational networks, together with the vastly increased and more complex interrelations between and within them, has made the context for development finance and international cooperation much more complex and difficult to deal with, and poses new challenges for the Multilateral Development Banks.

ANNEX E

Questioning development assistance and the role of the MDBs

The emerging fractured global order, the surge in private capital flows to emerging economies, and the growing heterogeneity of developing countries has led to a rather intense re-examination of the purposes, means and impact of development assistance. While there have been notable advances in social conditions in the developing world in the past fifty years, there is no consensus that financial and technical assistance from the rich nations have been decisive in achieving these gains.

During the 1990s the combination of diminishing resources of development assistance and growing demands for support from developing countries and transitional economies, focused attention on the effectiveness of international cooperation for development, these criticisms have reemerged with force. Keith Griffin and Terry McKinley articulated this sentiment clearly in the mid-1990s:

> "Looking back over four and a half decades of international economic assistance to the developing countries, it is clear that expectations of rapid and dramatic progress were too high, the economic analysis was faulty and the political assumptions were simplistic. In short, the supporters of foreign aid were embarrassingly naive. First, it is evident that foreign aid, contrary to original expectations, has not contributed to a noticeable acceleration of the rate of growth of developing countries. Second, where aid inflows are large in relation to the recipient's national product, relative prices are distorted in an anti-development direction. Third, the availability of foreign aid has made it easier for the governments of recipient countries to increase unproductive current expenditure, to expand the military and to reduce taxation. Fourth, there is no evidence apart from the occasional anecdote that either bilateral or multilateral aid programs have succeeded in reaching the poor."[47]

Other critics, such as Paul Blustein, see the whole development cooperation experiment as a colossal waste of money: '... the billions of dollars in foreign aid showered on poor countries since 1970 has produced no net impact on the overall economic performance of the Third World, nor on the economic policies of the recipient countries'.[48].

Graham Hancock goes even further arguing that 'aid is not bad, however, because it is sometimes misused, corrupt or crass; rather, it is *inherently* bad, bad to the bone, and utterly beyond reform' and that aid is 'the most formidable obstacle to the productive endeavors of the poor'. Not even the most acerbic critics of development assistance have reached the 33 level of Hancock's characterization, on the donor side, of 'the notorious club of parasites and hangers-on made up of the United Nations, the World Bank and the bilateral agencies', who have reached 'record breaking standards [of] self-serving behavior, arrogance, paternalism, moral cowardice and mendacity' and, on the recipient side, of the 'incompetent and venal' leaders and of 'governments characterized by historic ignorance, avarice and irresponsibility'

---

47 Keith Griffin and Terry McKinley, "A new framework for development cooperation. United Nations Development Programme", Human Development Report Office 1994, New York, NY, USA. Occasional Papers No.11.pp. 3-4.

48 Paul Blustein, "Foreign aid that doesn't seem to persuade", *The Washington Post*, 22 May 1997.

that engage in the 'most consistent and grievous abuses of human rights that have occurred anywhere in the world since the dark ages'.[49]

Against this radically pessimistic perspective on the impact of development assistance, a major study published under the title *Does Aid Work?* conducted by Robert Cassen[50] in the mid-1980s and updated in the mid-1990s, reaches a rather different and more balanced conclusion:

> "In the broadest sense, this report finds that most aid does indeed 'work'. It succeeds in achieving its development objectives (where those are primary), contributing positively to the recipient countries' economic performance, and not substituting for activities which would have occurred anyway. That is not to say that aid works on every count. Its performance varies by country and by sector. On the criterion of relieving poverty, even the aid which achieves its objectives cannot be considered fully satisfactory."

The perceived ineffectiveness of international development cooperation has been considered as an important contributing factor to explain what has been called 'donor fatigue', which is reflected in the diminishing public support for government spending on foreign aid [51]and in the reduction in Official Development Assistance flows. Considering the wide diversity of motivations for development assistance, the multiplicity of delivery channels and the different objectives of various programs, it is not surprising that when aid is viewed from a particular perspective - reducing poverty, empowering women, containing ethnic conflicts, helping refugees, building local capacity in the recipient country, or promoting donor country exports, among others - specific projects and programs can be seen to fall short of expectations. As Cassen stressed, it is important to evaluate development assistance undertakings in terms of their own specific objectives, which often differ from the goals that critics believe aid programs ought to pursue.

After reviewing a large amount of quantitative evidence, a report prepared at the World Bank[52] concludes that 'aid works'. Financial assistance leads to more rapid growth, poverty reduction, and gains in social indicators in developing countries with sound policies and institutions. However, rather than focusing on the amount of aid, the authors argue that good domestic policies and institutions are a necessary condition for aid to have a positive impact. According to their calculations, improvements in governance and policies of the same order of magnitude as those experienced throughout the developing world during the last decade could lift an additional 100 million people per year out of poverty. For this reason, they highlight the intangible benefits of development assistance, which include dissemination of ideas, education of future leaders and stimulation of policy debate within civil society, and emphasize the importance of building a broad base of institutions to ensure the delivery of public services.

In a major reversal of the arguments put forward in the 1960s and 1970s in favor of multilateral channels for development cooperation, during the late 1980s and the 1990s multilateral development cooperation agencies - in particular the World Bank group, the

---

49 Graham Hancock, *Lords of poverty*. New York, The Atlantic Monthly Press, 1989; pp. 183, 192-193

50 Robert Cassen, R. *Does aid work?*, Oxford, Clarendon Press, 1994,

51 Ian Smillie, *The alms bazaar*, Ottawa, International Development Research Centre 1995; pp. 124-146; and International Council of Volunteer Agencies, *The reality of aid*, London, Earthscan Publications,1996.

52 David Dollar and Lance Pritchet, *Rethinking aid: What Works, What Doesn't and Why*, Washington DC, World Bank 1998.

International Monetary Fund and the United Nations - have been questioned from many quarters. Most analysts would agree with Reginald Green's statement that 'there is a consensus that global economic institutions function poorly'.[53] For example, as the World Bank expanded its scope of action into policy-based lending to support policy reforms in borrowing countries (through structural adjustment loans), the distinctions between the roles of the World Bank and the International Monetary Fund - the two Bretton Woods sisters - became blurred in the 1980s. As a consequence, the question of whether the World Bank and the Fund should be merged and even abolished was raised by some critics of international organizations in general, even though it has not been taken seriously in most international policy making circles[54].

The conservative political critiques to MDBs have been expressed by the authors affiliated with the CATO Institute, a US right-wing think tank. The Institute sustains that although the lending agencies were touted as the answer to Third World poverty, they have proved to be expensive failures, doing more to retard than to advance economic progress throughout the developing world,[55] and that they have wasted billions in US tax dollars and created a well-funded lobby devoted to the expansion of failed foreign-aid programs. In their view, the 'World Bank is a financial cripple propped up by state guarantees and disguised government bailouts'[56]. Closing the World Bank would therefore be less damaging than waiting for its collapse. They propose five alternatives for the suspension of the Bank's operation: dissolution according to the Bank's articles of agreement, privatization, selling of its assets, swapping bank debts for equity, or unilateral withdrawal by individual countries.

On the left, a recent campaign against the World Bank and the IMF entitled '50 years is enough' has been mounted by a diverse coalition of 205 grassroots, faith-based, policy, women's, social- and economic-justice, youth, solidarity, labor, and development organizations[57]. They argue that the World Bank and the IMF are not fulfilling its mission to alleviate poverty. Instead these organization tend to finance bigger, more expensive projects - which almost always require the materials and technical expertise of Northern contractors; and which have often been associated with monumental environmental devastation and social dislocation. The campaign calls for fundamental changes in the goals, structure, operating procedures, policies and staffing of the World Bank and the IMF. In their view, this is the only way to make these organizations fully accountable, more transparent and more participatory of affected populations in their decision making standard procedures, and for them to pay attention to smaller-scale, local development alternatives.

The IMF and the World Bank have also been attacked because of their adherence to what are perceived as a rather rigid set of policy prescriptions, the so-called 'Washington Consensus'[58], imposed on borrowers as a condition for access to resources. According to Hans Singer, 'nowhere in the Articles of Agreement of the IMF (nor of the World Bank for

---

53 Reginald Green, "Reflections on attainable trajectories: reforming global economic institutions", in J. M. Griesgraber and B. Gunter, eds., *Promoting development*, London, Pluto Press 1995; pp. 28-81 and p. 66.

54 Doug Bandow and Ian Vasquez, ed. *Perpetuating poverty: The World Bank, the IMF and the developing world*, Washington, DC, CATO Institute 1995.

55 CATO Institute, *Handbook for Congress (105th Congress) on Multilateral Lending Agencies,* CATO, Washington, February 1997

56 Patricia Adams, *The World Bank´s finances: An International S&L Crisis*, Policy Analysis No. 215, CATO , Washington 1994.

57 '5o years is enough campaign', U.S Network for Global Economic Justice, Web site: www.50years.org

58 John Williamson, "Latin American adjustment: how much has happened?" Washington DC, Institute for International Economics, 1990.

that matter) is there any mandate to evolve or prescribe proper development policies to its member countries, let alone to develop the specific school of prescriptions now known as the 'Washington Consensus''.[59] Criticisms reached a high point in 1994 when the Bretton Woods institutions celebrated their 50th anniversary. Environmental groups and grass-roots activists disrupted their Annual Meetings with demonstrations and chanting the slogan 'fifty years is enough'.

The World Bank study on aid[60], which underscores the importance of good policies and institutions as a condition for aid to have a positive impact, argues that 'what is good policy is not something that is subjectively decided in Washington. Rather, lessons about good policy emerge from the experiences of developing countries. What we mean by good management is - objectively - what has led to growth and poverty reduction in the developing world'. However, considering the frequent changes in the policy advice provided by the World Bank over the last decades, and the changing nature of the evidence to support what are considered good policies, the claim to 'objectivity' has to be taken with a grain of salt.

The new roles that the IMF began to play in the late 1970, after the collapse of the fixed exchange rate regime, and especially during the 1980s as a result of the debt crisis, transformed this institution into 'both a police officer of economic policy and a mediator between debtors and creditors'[61]. IMF interventions to address the Mexican peso crisis of 1994-1995 and the East Asian crisis of 1997-98 have been severely criticized from many different quarters as going well beyond what would be an appropriate role for this institution[62]. According to Martin Feldstein, 'the IMF's recent emphasis on imposing major structural and institutional reforms as opposed to focusing on balance-of-payments adjustments will have adverse consequences in both the short term and the more distant future'. This is particularly worrisome in the case of South Korea where, as a condition for access to the resources required to stave off a temporary liquidity crisis, the IMF imposed some policy reforms that had been previously urged by Japan and the United States, but which the Korean government had balked at[63].

Another set of criticisms has recently been voiced by the International Financial Institution Advisory Committee of the US Congress, chaired by Professor Allan Meltzer. This report, which has been embraced by senior Republican politicians, argues that the IMF and the World Bank should be radically scaled down because the 'advent of deep global capital markets, willing to bear risk and prepared to channel substantial resources to emerging economies, has destroyed the rationale for much of the costly financial intermediation function that has been the (multilateral) Banks' main activity'. Among many other recommendations, the report proposes that all resource transfers to countries that enjoy capital-market access or with a per capita income in excess of US$ 4,000 would be phased out, and that starting at US$2,500 per capita levels, lending would be limited. Furthermore, to function more effectively, the Commission argues in favor of MDBs to be transformed into 'granting agencies', which would rely wholly on appropriated grant funds from rich-country governments for future assistance to the poor. Callable capital that would no longer be

---

59 Hans Singer, "Rethinking Bretton Woods from a historical perspective", in Greisgraber and Gunter *op. cit.,* p. 7.

60 Dollar, D and Pritchet, L. *Rethinking aid: What Works, What Doesn't and Why.* World Bank 1998, Washington, DC, USA; chapter 3

61 Minton-Beddoes, Z. Why the IMF needs reform. *Foreign Affairs*, 1995, 74 (3) , pp. 127

62 Kapur, D. The IMF: a cure or a curse? *Foreign Policy* 1998 , 111, 114-129

63 Feldstein, M.. Refocusing the IMF, *Foreign Affairs* 1998, 77 (2), 20-33

needed would be transferred to regional development banks, which in turn would be the sole providers of multilateral aid to their regions, while the World Bank would provide assistance to Africa and some countries in Eastern Europe and Central Asia.

The US Treasury Department responded forcefully to the Meltzer report and disputed its recommendations, arguing that most of them were based on a misinterpretation of the roles that MDBs play and of the way they function. With the support of MDB officials, Dr, Lawrence Summers, US Secretary of the Treasury, strongly defended the MDBs, even though several of the less controversial recommendations of the Meltzer report - for example, increasing development assistance for the poorest countries, limiting the role of MDBs in countries that enjoy widespread access to international capital markets - were endorsed.

Table E-1 summarizes the proposals of the Meltzer report on the role of MDBs, as well as the response of the US Treasury Department.

Interestingly enough, some of the recommendations made by the Meltzer report bear a striking resemblance to the points made in an article by Michael Klein offering a futuristic assessment of the role of the World Bank in 2044, one hundred years after the Bretton Woods institutions were founded. Klein's article envisaged a situation fifty years ahead in which the growth of private sources made the financial role of the World Bank superfluous, the lender of last resort functions are exercised by privately funded standby liquidity schemes, voluntary and mandatory global standards and better global governance have reduced the need for conditionality, a global safety net has reduced its concessional assistance functions, much of the information and advisory functions have been taken over by private firms, and the World Bank has been transformed into an endowed foundation which fund innovative schemes to improve governance and fight poverty. [64] It would almost appear that this speculative view on the role that the World Bank could play fifty years hence inspired some of the immediate recommendations made by the Meltzer Commission.

---

[64] Michael Klein, "One hundred years after Bretton Woods: A future history of the World Bank Group", *European Investment Bank Papers*, Vol. 3, No. 2, 1998, pp. 30-59.

TABLE E-1

Meltzer Report: Proposals regarding the MDBs and responses from the US Treasury Department

MELTZER REPORT	US TREASURY DEPARTMENT RESPONSE ON MULTILATERAL DEVELOPMENT BANKS
Development Banks must be transformed from capital-intensive lenders to sources of technical assistance, providers of regional and global public goods, and facilitators of an increased flow of private sector resources to the emerging countries. Their common goal should be reduce poverty, their individual responsibilities should be distinct.	The production of global public goods, and the provision of technical assistance are complementing, rather than replacing, the Bank's other development priorities for addressing poverty reduction. The World Bank and other development institutions have the potential to significantly expand their efforts to promote global public goods and can make an enormous contribution in helping to push the frontier of international collaborative efforts in this area. Regional MDBs should continue to emphasize regional projects that address cross-country concerns. Examples such as the Consultative Group on International Agricultural Research (CGIAR), the Green Revolution, and the onchocerciasis control program for river blindness in Africa all demonstrate that innovative collaboration among the World Bank and other official bodies delivers results. Regional development banks also should continue to increase their emphasis on developing regional approaches to regional development issues.
The IMF should write-off in entirety its claims against all HIPCs that implement an effective economic development strategy its conjunction with the World Bank and the regional development institutions	Although the Treasury Department shares the Commission's goal of substantial debt relief for HIPC countries committed to economic reform and poverty reduction, it does not support a complete write-off of IFI debt, for the following reasons: 1. Under the enhanced HIPC initiative the total cost of debt relief to the IFIs will be about $14 billion. Financing the initiative poses a substantial challenge for the international community; even after the IFIs maximize the use of their internal resources, bilateral donor contributions of at least net present value (NPV) $3.6 billion will be required to cover the full costs of IFI participation in the initiative. In order to completely eliminate HIPC debt, costs for the IFIs would rise dramatically, to roughly NPV$43 billion. It is not realistic to expect that the IFIs and bilateral creditors would be able to finance these additional costs. 2. A significant portion of new concessional assistance from the MDBs comes from resources that are being paid back to the institutions by previous borrowers. The Commission's recommendation would cut by almost half or about $31 billion (nominal) over the next twenty years the concessional windows of the MDBs. Reflows to IDA would be cut by roughly 40 percent, reflows to the IDB's concessional window would be reduced by about one-third, and reflows to the African Development Fund would be cut by over 80 percent. Not only would this result in substantially fewer funds for future lending to the HIPCs, it would also leave fewer funds for non-HIPC countries that use concessional loan facilities at the MDBs. To the extent that complete debt forgiveness would also require reducing development assistance for poor non-HIPC countries, it would in effect be 'the poor funding the poor'. Concessional finance available for Africa, the continent with the most HIPCs, would be hurt most of all. 3. Writing off 100 percent of the debt for a specific group of impoverished countries poses a severe moral hazard for other poor countries. In a sense, 100% debt cancellation rewards those poor countries with very high debt levels in a manner that is likely to reduce future development assistance for other poor countries.
All resource transfers to countries that enjoy capital market access (as denoted by an investment grade international bond facility) of with a per capita income in excess of $4000, would be phased out over the next 5 years. Starting at $2500 per capita income, official assistance would be limited	The Treasury Department finds this recommendation neither desirable nor feasible. A country's potential access to private markets at some level does not automatically translate into an availability of private finance at the rates, maturities and volumes appropriate for the full range of purposes necessary to lay the basis for sustained growth and poverty reduction. Even relatively productive emerging markets face severe limitations in the volume of private capital that is reliably available for long-term development investments with the medium to longer-term maturities that are necessary. Moreover, private capital that is available comes with interest rates that are prohibitive for development programs. These market limitations are of particular importance with respect to the availability of support for development programs such as policy-based sector reforms. If the Commission's recommendations were applied as written, countries as diverse as Brazil, Indonesia, Turkey, and South Africa – where important, long-term U.S. strategic and economic interests are clearly at stake -- would be denied access to MDB assistance. Moreover, they are home to a substantial share of the worlds poor. For example, more than 36 percent of the population of Latin America lives on less than $2 per day. Graduation policies designed with a fixed and excessively low threshold risk worsening economic outcomes in these countries and increasing the risk of future crises. This could undercut or prolong the path to sustainable market access, and ultimately delay the time when these governments will grow out of the need for official support. MDB support for emerging market economies needs to be more selective and focused on areas where it can increase their overall capacity to access private capital resources on a more durable basis. MDBs should emphasize lending to: ▪ promote key public investments, particularly for the public goods that will not be adequately supplied by private markets; ▪ attract additional private capital flows, by among other things, reducing obstacles to private investment; and counteract temporary disruptions in access to private external capital.

	Accordingly, MDBs should: ▪ have a strong presumption against lending where private finance is available on appropriate terms; ▪ reduce the share and volume of their lending to emerging economies over time, with complete graduation as a clear objective; and ▪ use their loan pricing flexibility more systematically to encourage graduation.
MDB support for physical infrastructure and social service projects in the poorest countries should be provided through grants rather than loans and guarantees.	This recommendation would limit the overall availability of financial assistance to the poorest. Moreover, moving to an all-grant system would have negative long-term financial implications for the institutions and their shareholders. Over time, the effect would be to eliminate the reflows that derive from concessional loans (mainly repayments of principal) and that currently fund a substantial portion of the institutions' new concessional loan commitments. Individual donors rely, almost invariably by law, on annual legislative allocations of funding to support MDB operations in the poorest countries (i.e., concessional loans for the most part). They cannot provide the long-term guarantee of future resources that the Commission's grant-based approach would require. The lending terms of all four MDB soft-loan windows are already highly concessional; e.g., IDA credits have a grant element of about 70 percent at current interest rates. The World Bank also provides selective grants for research and other global public goods, HIPC debt relief, and to spur development in post-conflict countries. The IDB also provides some targeted grant funding. The current approach of relying largely on highly concessional credits covers the administrative costs of lending. It has two other advantages that would be lost under an all-grant approach. ▪ Over time, repayments on past credits play a major role in funding new credits that would have to be offset by donors to maintain the level of new commitments. For example, reflows will finance over 38 percent of IDA-12 lending – the most recent replenishment of IDA resources. This recycling of IDA repayments into new lending favors the poorest countries in that the more advanced former and current recipients of IDA now account for roughly one-half of current reflows. ▪ The reality that credits must eventually be repaid helps to build financial discipline and debt management skills in borrowing countries. It also provides an added incentive to ensure that borrowed funds are used selectively and wisely. ▪ There is scope for greater differentiation of soft-loan lending terms among the poorest countries, providing the very poorest and least creditworthy borrowers with the highest degree of concessionality. It is important to ensure that the stock of highly concessional debt is accumulated and managed in a way that minimizes the prospect of future debt servicing problems. There is positive value in maintaining the lending approach of the MDBs and consequently, we it is not desirable to redesignate them as 'Agencies'.
Development Agencies should be precluded from financial crisis lending	While MDB financial crisis lending should be limited to exceptional cases, direct MDB support in crises can be critical to the success of recovery programs by helping to minimize long-term damage, sustaining and restoring development momentum, and contributing to intensified economic reform and restructuring. The MDBs are thus particularly well-positioned to provide significant value added in the effort to: ▪ avoid unnecessary fiscal contractions in fiscal expenditures; ▪ restructure banking and other financial institutions; and ▪ minimize the adverse impact of the crisis on the poor by, for example, strengthening social safety nets. The upsurge in MDB 'crisis' lending in the late 1990s, most of which was provided on shorter maturities and higher rates, was appropriate in the context of the acute and generalized reduction of private capital flows to emerging economies. The risks were high. However, the economic results that have emerged – in terms of helping to put in place fundamental reforms needed to restore private sector confidence – have been broadly positive. A large measure of economic and financial stability has been restored and economic growth prospects are now far better than would otherwise have been expected. MDB intervention was achieved without any additional budgetary costs for MDB member governments. Moreover, the existing capital base of the three largest MDB hard loan windows (the IBRD, IDB, and ADB) is sufficient to maintain a cushion in lending capacity that would enable these institutions to respond quickly with a substantial, but temporary, expansion of lending if justified by a future adverse shift in global financial conditions. While MDB hard-loan lending rose sharply to help members deal with the recent financial crisis, it has now returned to levels more consistent with, and in the case of the IBRD well below, the pattern of pre-crisis lending. The long-term pre-crisis trend shows that annual MDB hard-loan window lending has been relatively steady in both the IDB and ADB, and actually declining in the IBRD despite the addition of nineteen new member countries in Eastern European and the former Soviet Union.

The 'poverty reduction grants' to eligible countries (poor countries lacking capital market access) should be paid directly to service providers after there is independently verified delivery of service.	The Treasury Department finds this approach not practical as standard practice. Most social sector development operations have a much broader focus and scope than providing a discrete and easily quantifiable service. In fact, many require a series of concerted actions over a period of many years, and with sustained and extensive government involvement. For example, a rural school or health clinic could well (and we would argue often should) be built by an independent contractor. But the longer-term viability of the school, and therefore whether it actually delivers the development benefits that are intended, requires regular government involvement and support through the budget process. This proposal could: ▪ undermine the basic objective of building local capacity to implement projects effectively, including the need to improve the quality and performance of the government institutions involved, and to build transparent procurement systems; ▪ reduce private sector and civil society interest in bidding for selection as a service provider; the built-in payment delays specified by the Commission's proposal would likely be a disincentive to smaller private firms and NGOs, who would need to seek interim financing that could well be in short supply; and ▪ increase the cost of projects, because of additional risks associated with bridge financing requirements, the additional costs of the independent verification process, and the potential additional costs of outsourcing core services.
World Development Agency would have less need for its current callable capital. Some of the callable capital should be reallocated to regional development agencies, and some should be reduced in line with a declining loan portfolio	The Treasury Department finds the Commission's proposals are either desirable or feasible. Shareholder capital in the MDBs has two components: paid-in and callable. **Paid-in capital** is the amount of funding that countries actually transfer to the institutions to support their market-based lending operations. **Callable capital** is funding that shareholder countries have formally agreed to make available on a contingency basis in the event that the bank is not able to meet its liabilities. Callable capital therefore represents the contractual commitment of shareholders such as the United States. Paid–in capital is typically a fraction of the total capital of a bank. For example, for the IDB's seventh capital increase in 1995, paid-in capital represented only 2.5 percent of the total capital increase. The Banks issue bonds against their assets, including the paid-in capital and the callable capital of investment grade shareholders (primarily the industrialized countries) and use the proceeds to provide loans for development projects. The Commission does not appear to have taken into account a number of major legal and financial issues that would be direct obstacles to the callable capital transfers/reassignments it is recommending. The World Bank is one of the global capital market's largest borrowers and is widely viewed as one of its strongest. The Bank currently has about $116 billion of publicly-held bonds outstanding that have been issued against its callable capital. A transfer of this underlying asset would be fundamentally inconsistent with the terms and conditions on which these bonds were issued; there is a real risk that it could be potentially disruptive to the market, and it would clearly raise a host of highly complex legal and contractual issues. Beyond this, the World Bank's 181 member governments have specifically given callable capital commitments to specific institutions, typically through a complex legal and legislative process. Any material changes to these specific commitments would require most (perhaps all) of the shareholders to return to their own legislatures for the necessary approvals and amendments. Apart from the major technical obstacles to a callable capital transfer of the kind recommended by the Commission, any such transfer would need to gain a level of international support that is highly unlikely. Specifically, it may require amendment of the Articles of Agreement of each of the affected institutions, which would require at least a 75 percent majority vote of the shareholders.
Eliminate direct MDB loan and equity investments in the private sector, closing the IFC, and limiting future support for technical assistance and the dissemination of best practices standards. In addition, eliminate the Multilateral Investment Guarantee Agency, which provides political risk insurance to private investors.	The Commission's recommendation is premised on a view that the public benefits (even in poor countries) resulting from official credit for private-sector entities are not necessary, and that official credits crowd out private investors. This view ignores some important realities: ▪ capital markets are imperfect and the presence of private sector investment opportunities does not mean, *ipso facto*, that they will be financed; ▪ private capital does not flow to risky countries in the volume and for the purposes necessary to stimulate enduring and equitable growth; ▪ direct MDB engagement with the private sector has been an instrument for wider private sector development reforms; and ▪ limited MDB lending to the private sector has catalyzed many times its amount in new and additional private flows. ▪ U.S. interests and the realities of developing country and emerging market finance fully justify carefully focussed MDB support for private sector operations: ▪ medium and long-term domestic finance is virtually unavailable for many sectors/projects in most of the world's countries; ▪ private finance can be extremely susceptible to short-term disruption; ▪ private sector finance for properly structured enclave investments in the poorest countries can yield substantial social benefits; ▪ modest amounts of MDB finance can privatize state-owned enterprises, providing both social gains and new opportunities for subsequent private investment; ▪ despite liberalization and reform during the 1990's, emerging market risk remains unacceptably high, and project returns too low, for most private investors and lenders; and ▪ despite substantial progress in reforming the overall investment climate, uneven emerging market accounting practices and investment regulation still present substantial challenges to financial due diligence in these areas which further discourages long-term domestic lending.

	▪ Transactional finance from MDB private sector operations is an integral component of the MDBs' broader sector restructuring and policy reform efforts in virtually every country in which the MDBs are active. Given the real obstacles that still exist to long-term emerging market lending and investment, MDB private sector operations are making important and clear contributions to create new opportunities for investment, reduce risk and volatility, and increase access to capital. In particular, the private sector windows play the following vital roles: ▪ Investment Climate Development by promoting sound economic policies, divestiture of state-owned enterprises, capital market development, investment rules and protection, and free flow of capital; ▪ Risk Mitigation through innovative co-financing and guarantee arrangements, application of performance clauses to government partners, and early due diligence; and ▪ Market Access Facilitation by restoring investor confidence in crisis times by investing in those disrupted emerging markets with sound economic and investment climate fundamentals. The MDB private sector windows have been instrumental in catalyzing the additional private funding, and the private sector development more broadly, which would not otherwise have occurred given the realities of developing country finance. Given the risk of crowding out private finance, direct MDB support for the private sector must be provided very selectively and with great care. There would be no compelling case for involvement by the MDBs in the private sector if all they brought to the table was cheaper finance.
All countries and regional programs in Latin America and Asia should be the primary responsibility of the area's regional bank. The World Bank should become the principle source of aid for the African continent until the African Development Bank is ready to take full responsibility. The World Bank should be the development agency responsible for the remaining poor countries in Europe and the Middle East.	The World Bank's global focus and unparalleled cross-regional experience represent an enormously valuable asset to developing countries in all of the regions, and to the shareholder community more broadly. In an increasingly integrated world economy, the World Bank should be at the centre of the global effort to develop and deliver core program lending and targeted project finance aimed at building and supporting the institutions of development and poverty reduction. The location, shareholding structure, and operational experience of regional banks are also important assets, but in general they are not able to match the technical resources of the World Bank. Indeed, knowledge transfer across regions is an intrinsic asset of the World Bank. Increasing cooperation among the MDBs, sharpening their areas of comparative advantage, and reducing operational overlaps would increase the system's overall development effectiveness and should be pursued as a matter of priority. It makes little sense for the regional development banks or, indeed, the World Bank, to build and maintain a capacity to undertake every kind of activity relevant to development in every country in which they could play a role. Responsibility for certain kinds of project lending should more often shift to the regional development banks, where they have proven expertise. The US has been working aggressively to give these views concrete expression in the form of formal Memoranda of Understanding between the World Bank and the regional banks that articulate a division of labour reflecting comparative advantage and selectivity. In addition to these MOUs, the Country Assistance Strategies (CASs) are continuing to address the appropriate division of labour in borrowing member countries. The World Bank and IFC produce joint CASs designed to maximize Bank Group synergies in promoting private sector development. As part of the process of improving institutional focus and specialization across the system, the World Bank will need to deliver on its commitment to accept a more coordinating or supporting role with respect to other agencies. For example, other agencies and bilateral donors that often work closely with NGOs often have a clear comparative advantage in the area of humanitarian assistance in post-conflict situations.

ANNEX F

External Finance Requirements of Developing Countries

1. INTRODUCTION

As we enter the new century, international efforts converge to the fundamental objective of significantly reducing poverty across the world. It is commonly accepted that economic growth is needed to achieve this objective, but it is not clear how much of growth is needed, or how much of external financing is required to sustain higher growth. It is also consensus that only growth is not sufficient. Yet again, it is not clear which other policies can effectively contribute to poverty reduction, and whether or the extent to which such policies compete with growth for the same pool of financial resources.

This study aims to cast new light upon these issues. To this end, we estimate the external financing needs of developing countries over the 2000-2009[65] period using a savings-gap model (see Lensink and Van Bergeijk, 1991).

BOX 1
Summary points

- Savings and investment trends exhibited a dissimilar behaviour across developing regions during the 1990s. For East Asia and Pacific they were fairly stable and fluctuated around similar levels, while for other regions they were variable, with a gap between them – the savings-investment gap.
- Such a gap being big implies sizeable net external financing needs, projected to be within the range of 1.9%-2.4% of developing countries' GDP over the immediate period 2000-2002 (***base scenario***), which is of similar order of magnitude when compared to the current account deficit of 2% observed over 1991-97. If principal payments are added, such needs reach 4.5% of their GDP. Of the total of financing required, 84% correspond to the needs of middle-income countries, and 16% to the needs of low-income countries.
- By developing regions, net external financing needs vary considerably, from 0.6% of the GDP in South Asia to 6.5% in Sub-Saharan Africa.
- The major determinants of such financing needs are the savings-investment gap (as above mentioned) and interest rate payments on external debt. In South Asia the savings-investment gap will be almost offset by workers' remittances.
- To halve extreme poverty by 2015, Sub-Saharan Africa and Latin America will need net annual external financing over the entire period equivalent to 12.7% and 6.2% of their GDPs, respectively. For the immediate 2000-2002 period, external financing needs will be 17.7% and 12.7% if principal payments are included.
- Supplementary financing will be needed for additional recurrent expenditures, of utmost importance for very poor countries that face urgent needs in their social sectors. Alternative financing should be sought for that, for example through enhancing the HIPC initiative.

The exercise involving the use of the savings gap model consists of two basic steps. First, based on the incremental capital-output ratio (ICOR), it is calculated the investment rate required for achieving a certain growth rate target. Second, it is calculated a financing gap between the investment required and national savings. This gap should thus be fulfilled with external financing.

65 Estimates for the 2000-2015 period are also offered.

In the past few years some scepticism has been raised in certain academic and policy circles regarding the use of the gaps approach for the purpose of estimating external financing needs. According to that view, the past 40 years of development assistance have suggested that the assumptions underlying the gap models may not hold.[66]

A number of limitations have been pointed out, the most important being: first, the presumption that all external financing will be used for investment may be too strong. Some might be used for consumption. This implies that domestic savings is actually an endogenous variable, sensitive to changes in the levels of external finance. Moreover, it may also be sensitive to the level of economic growth. Second, the constant ratio of investment rate to growth rates may not hold in the short-run. Third, changes in terms of trade are not accounted for. And finally, but no less important, the model being supply-side focused, it ignores the external demand scenario, which is of particular importance for countries that have exports as their engine of growth.

While these are important points, it should be clear that the savings gap model can prove useful in estimating long-term financing needs for countries expected to experience sustained growth. First, empirical evidence points to a stable long-term relationship between investment and economic growth (while being true that in the short-run the relationship appears rather variable); and although causality might run either way, it is of little dispute that investment is a crucial factor behind productive capacity and long-term growth. Second, it might be true that some external financing is used for consumption rather than investment, but this phenomenon by itself does not invalidate the predictions of the model. It just raises the question of whether additional external financing may not be properly allocated among different purposes.

The information the gap model provides can serve as a guideline to how much additional financing developing countries need in order to meet sustained growth. In particular, it is a way of breaking with past trends of provision of insufficient development assistance, a phenomenon that helps to explain a good deal of poor economic performance across the developing world, particularly the poorer countries, bloated by issues such as external debt overhang.

The failure to use the gaps approach would have very unwelcome consequences. The development community would no longer have access to macro pictures, being instead thrown into a darkness which fragmented information based on micro assessments would not be able to illuminate. This scenario can be only beneficial to those who stand against development assistance. But for the development community the gaps approach can continue to serve as a useful framework, if improved and used with restraint.

This study is structured as follows. We first provide a brief analysis of trends of savings and investment in developing countries during the 1990s. Second, we offer estimates of the external financing needs of developing countries, both by income-groups and by developing regions. This is followed by a complementary exercise in which it is estimated the external financing needed to achieve the international target of halving extreme poverty in the developing world by 2015. Finally, we discuss the role of recurrent expenditure in reducing poverty, as well as alternative ways of financing it.

---

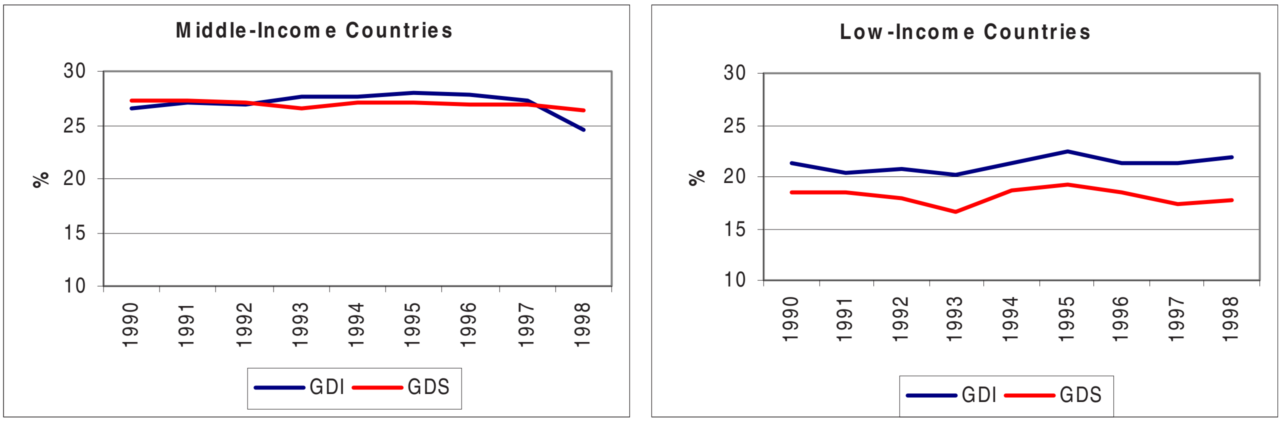
66 For a thorough critique of the savings gap model and its variants, see Easterly (1999).

2. TRENDS OF SAVINGS AND INVESTMENT

In assessing the financing needs of developing countries, a first useful approximation is to look at the trends of savings and investment rates in low- and middle-income countries during the 1990s.

It can be seen from Figure1 that, first, there is a clear saving-investment gap in both low- and middle-income countries for most of the 1990s. Second, the trends of savings and investment in low-income countries are stable, with investment rates situating slightly above 20 percent (of GDP) and savings slightly below that level (see also Table 1 below). Third, in middle-income countries the trends are less stable, particularly the investment trend, which is upward until 1995 with a reversal from then on, with a marked decline in 1998. The drop in 1998 is associated with the financial and currency crises and their contagion effects that hit different (but more acutely middle-income) countries across the world.

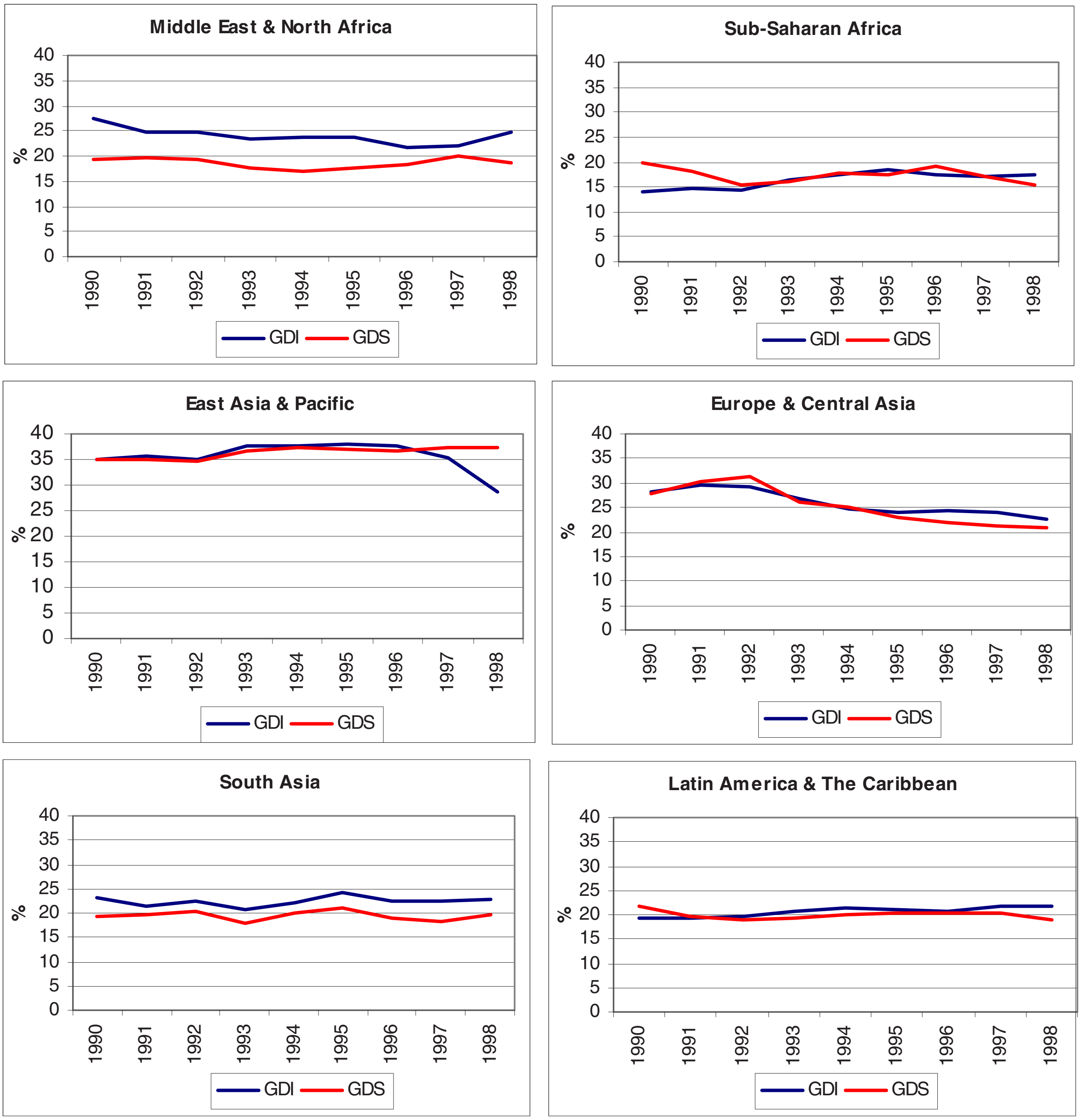
FIGURE 1
Investment and Savings by group of countries
(% GDP)



Source: Author's calculation based on data from the World Development Indicators CD-ROM 2000.
GDI and GDS stand for gross domestic investment and gross domestic savings, respectively. They are weighted averages drawn from countries for which data were available. The list of countries by group can be found in Annex 1.

But a less homogenous picture is found at the regional level. (see Figure 2).

FIGURE 2
Investment and Savings by Regions
(share of GDP %)



Source: Author's calculation based on data from the World Development Indicators CD-Room 2000. GDI and GDS stand for gross domestic investment and gross domestic savings, respectively. They are weighted averages drawn from countries for which data were available. The list of countries by region can be found in Annex 1.

Figure 2 shows the trends of savings and investment rates over the 1990s for each major developing region – East Asia & Pacific, South Asia, Middle East & North Africa, Sub-Saharan Africa, Europe & Central Asia and Latin America & the Caribbean.

The East Asia & Pacific region exhibits positive trends in investment and savings levels until 1995, with a slight decline in investment in 1996 and 1997, and a sharp drop in

1998 due to the adjustment effects of the East Asian crisis. By 1997 savings were around 37 percent of GDP and investment, 35 percent (Table 1).

The trends for all other developing regions are less stable. Investment levels in South Asia are variable, while in Middle East & North Africa and Europe & Central Europe they exhibit a declining trend. The fall in the latter reflects the transition of most countries of the region from a planned to a market economy. In Sub-Saharan Africa and Latin America & the Caribbean a gradual increase in investment levels took place, as a recovery of the previously depressed levels due to the debt crisis of the 1980s.

In sharp contrast to East Asia and Pacific, savings levels show variability in South Asia and Middle East & North Africa, and a declining trend in Sub-Saharan Africa, Europe & Central Asia and, though less markedly, in Latin America & the Caribbean as well.

In addition, all such other developing regions differ from the East Asia and Pacific by exhibiting much lower investment and savings levels and, most importantly, by showing a marked, though variable, savings-investment gap. The average level of investment over 1990-98 of such regions range from 22 percent to 26 percent of GDP, while savings vary between 17 percent and 25 percent (Table 1).

TABLE 1

Investment (GDI) and Savings (GDS), 1990-98

% GDP

Region/Group		**1990**	**1995**	**1998**	**1993-97**	**1990-98**
East Asia & Pacific	GDI	35.0	38.1	28.8	37.3	35.6
	GDS	34.8	37.1	37.4	37.0	36.3
South Asia	GDI	23.2	24.2	22.8	22.4	22.5
	GDS	19.4	21.1	19.5	19.3	19.5
Middle East & N. Africa	GDI	27.4	23.8	24.7	22.9	24.0
	GDS	19.4	17.8	18.6	18.1	18.7
Sub-Saharan Africa	GDI	14.1	18.3	17.5	17.4	16.4
	GDS	19.9	17.3	15.5	17.5	17.4
Europe & Central Asia	GDI	28.3	24.1	22.5	24.8	25.9
	GDS	28.0	23.1	21.0	23.5	25.3
Latin America & The Caribbean	GDI	19.3	21.1	21.9	21.1	20.7
	GDS	21.6	20.4	19.1	20.0	20.0
Low-Income Countries	GDI	21.4	22.5	21.8	21.3	21.2
	GDS	18.5	19.2	17.7	18.1	18.1
Middle-Income Countries	GDI	26.5	28.0	24.6	27.7	27.0
	GDS	27.2	27.0	26.3	26.9	26.9

Source: Author's calculation based on data set from the World Development Indicators CD-Room 2000. Regional/Group GDI and GDS are a weighted average drawn from countries for which data were available. The list of countries can be found in Table F-1.

The savings-investment gap is a first indication of the amount of external finance that developing countries need in order to meet growth and development. However, a more accurate way of assessing the countries' external financing needs is by comparing domestic investment with national rather than domestic savings, as the former takes account of interest payments on external debt (as well as transfers). The difference between domestic investment and national savings is a measure fairly comparable with the current account of the balance of payments.

The annual current account deficit of developing countries over the period 1995-97 was on average (of current US$ dollars) 81 billion, being reduced to US$ 54 billion in 1998 (Global Development Finance Report 1999), partly because of the adjustment measures adopted in response to the East Asian and Russian crises. The 1998 deficit corresponds to 0.5 per cent of the countries' combined GDP. For 1999 a surplus of 0.3 of their GDP was estimated, the same ratio being predicted for the year 2000. For 2001 and 2002 deficits of 0.2 and 0.4 per cent are being respectively forecast (Global Development Finance Report 2000).

Net external finance, which differs from current account deficit by including change in reserves, peaked at US$ 183 billion in 1995, and then receded to US$ 102 billion in 1998.

TABLE 2

Net External Finance and the Current Account Deficit of Developing Countries 1991-98

	1991	1995	1997	1998	1999	2000	2001	2002
Net external finance (U$ billion)	89.0	183.1	110.8	102.1				
Current account deficit (U$ billion)	51.2	87.3	84.4	53.6				
Current account deficit % GDP[1]				0.5	-0.3	-0.3	0.2	0.4

Source: World Development Finance – Analysis and Summary Tables 1999 and 2000.
1. Estimate for 1999 and forecast for 2000-2002.

The shift from an estimated surplus in 1999 to a deficit in 2002 reflects a positive scenario of higher growth over the period 2000-2002 - 4.6 percent in 2000 and 4.8 percent in 2001 and 2002 - as compared to the estimated 3.1 percent in 1999.

3. EXTERNAL FINANCING NEEDS OF LOW- AND MIDDLE-INCOME COUNTRIES

Based on a savings gap model[67] (i.e. a version of the minimum revised standard model of the World Bank), we estimate the net external financing needs of developing countries over the 2000-2009 period (the model, assumptions and set of parameters used are presented in Annex 2). The net external financing needs estimated by the model essentially correspond to the countries' projected current account deficits over the period being covered.[68] It takes account of four major determinants of the current account: the savings-investment gap (which is equivalent to the difference between imports and exports of goods and services net of factors), profit remittances, interest payments on external debt and unilateral transfers.

We consider a ***base scenario*** in which low-income and middle-income countries are expected to experience similar growth rates. Such growth rates are fully consistent with the

[67] We chose to work with a savings gap model rather than a two-gap model because it is predicted sustained growth, which implies economies running near full capacity, situation in which the savings gap tends to be the major binding constraint. It however abstracts from the fact that in the initial years of economic recovery the trade-gap might be the major binding constraint, especially in economies that are in an intermediate stage of industrial development.

[68] It therefore does not take account of the financing needs of the capital account, for example the financing necessary for principal payments.

ones used in the simulations by regions, most of which based on the current forecast growth reported by the Global Development Finance 2000 (see below).[69]

TABLE 3

Net External Financing Needs of Developing Countries, by income-country groups

Base scenario Annual average U$ billion at 1998 prices

	2000-2002	% GDP	2000-2009	%GDP
Developing Countries	141.3		232.0	
Low-Income Countries	23.2	2.4	34.5	3.0
Middle-Income Countries	118.1	1.9	197.5	2.8

Source: author's calculations.

Our projections indicate that the annual net external financing needs of developing countries over the period 2000-2002 will be US$ 141 billion (Table 3). This amount is far bigger than the current account deficit observed for such group of countries in 1998 - US$ 54 billion - or than the external finance provided to them in the same year - US$ 102 billion (see Table 2).

This difference reflects higher financing needs associated with a projected economic recovery for the developing world. But such projected financing needs in proportion to the GDP are within the range of 1.9-2.4 percent (see Table 3) This figure is of similar order of magnitude when compared to the current deficit of 2 percent observed over the years 1991-97 (World Development Finance 2000). In this period growth resumption was observed across the developing world thus serving as a better basis of comparison than the recession year of 1998.

Of the total external finance required, 84 percent (US$ 118 billion) correspond to the needs of middle-income countries, and 16 percent (US$ 23 billion) to the needs of low-income countries. The annual average external financing needs for the years 2000-2009 are higher as the projected growth rates of the initial period are expected to continue over the entire period.

It should be recalled that such financing needs as defined here do not take into account those external obligations recorded in the capital account of the balance of payments. If principal repayments are for example accounted for, then the external financing needs of low-income and middle-income countries will be 3.9 percent and 4.4 percent of their GDP, respectively.

69 The growth rates used for low-income and middle-income countries are 5.0%, 5.3% and 5.5% for 2000, 2001 and 2002, respectively. For the 2003-2009 period, the growth rate of 2002 was used.

TABLE 4
Principal repayments
Annual average %GDP

	2000-2002
Low-Income Countries	1.5
Middle-Income Countries	2.5

Source: Global Development Finance Country Tables 1999.
Principal repayments correspond to the amount due for 1998 divided by the projected real GDP over 2000-2002.

Table 4 reports the ratio of principal repayments to GDP in low- and middle-income countries under the very conservative assumption that the 1998 principal repayments will remain constant in real terms over the 2000-2002 period.

4. EXTERNAL FINANCING NEEDS OF DEVELOPING REGIONS

Net external financing needs differ quite considerably across developing regions. Table 5 reports the annual average external financing needs of 6 developing regions over the 2000-2009 period under the ***base scenario***. In addition, it provides estimates of the annual financing required to halve poverty by 2015 – the ***poverty-reduction target scenario***.

Growth rates under the ***base scenario*** are drawn from the current forecast of The Global Development Finance 2000. The report offers growth rates for each developing region over the 2000-2002 period.[70] Such growth rates are similar to those experienced by the regions between 1993 and 1997, which was the period we relied upon to obtain some of the key parameters of the model, such as ICOR and savings rates. East Asia & Pacific was the exception to that, as the region's average growth was 8.5 percent[71] over the 1993-97 period, while the growth being forecast in the report falls into the range of 6.1 percent -6.6 percent. In order to keep a degree of consistency between the parameters used in the simulations, in the case of East Asia & Pacific we used the growth rates observed in the past rather than the ones being currently forecast.

In the ***poverty-reduction target scenario***, it is used those growth rates believed to be necessary (though not sufficient) to halve extreme poverty (i.e. those living on less than U$ 1 dollar a day) by 2015 in each developing region. These growth rates are obtained from DFID (1999). The growth rates used to generate each of the above scenarios are displayed in Table 6.

[70] For the remaining years – 2003-2009 – growth rates being forecast for 2002 were used.
[71] This growth rate is based on weighted growth rates of the countries of the region from which parameters were obtained. Such countries are listed in Annex 1.

TABLE 5
Net External Financing Needs of Developing Countries, by Regions
Annual average

	Base scenario[1] 2000-2009		*Poverty-reduction Target scenario[2]* 2000-2015	
	U$ billion [3]	% GDP	U$ billion [3]	% GDP
East Asia & Pacific	53.2	1.9	n.d.	n.d.
South Asia	4.4	0.6	4.9	0.5
Middle East & North Africa	42.4	5.8	57.8	7.2
Sub-Saharan Africa	27.7	6.5	86.4	12.7
Europe & Central Asia[4]	66.8	5.3	24.9	2.4
Latin America & The Caribbean	26.6	0.9	281.1	6.2

Source: author's calculation. 1. Growth rates used in the ***base scenario*** are drawn from the current projections of the Global Development Finance 2000. 2. Growth rates used in the ***poverty-reduction target scenario*** are drawn from DFID (1999). 3. The values are set in 1998 constant prices. 4. For Europe & Central Asia, financing needs under the ***poverty-reduction target scenario*** are smaller than under the base scenario, because in spite of its slightly higher growth rates, in ***the poverty-reduction target scenario*** a gain in capital efficiency is assumed to take place from the 6th year on.

TABLE 6
Annual growth rates
(%)

	Base scenario[1]			Poverty-reduction target scenario[2]
Years	*2000*	*2001*	*2002[3]*	*2000-2015*
East Asia & Pacific	***8.5***	***8.5***	***8.5***	***4.3***
South Asia	***5.9***	***5.8***	***5.5***	***5.5***
Middle East & North Africa	***3.5***	***3.6***	***3.6***	***4.7***
Sub-Saharan Africa	***3.2***	***3.7***	***3.8***	***8.2***
Europe & Central Asia	***2.5***	***3.4***	***3.6***	***3.9***
Latin America & The Caribbean	***3.6***	***3.8***	***4.4***	***10.2***

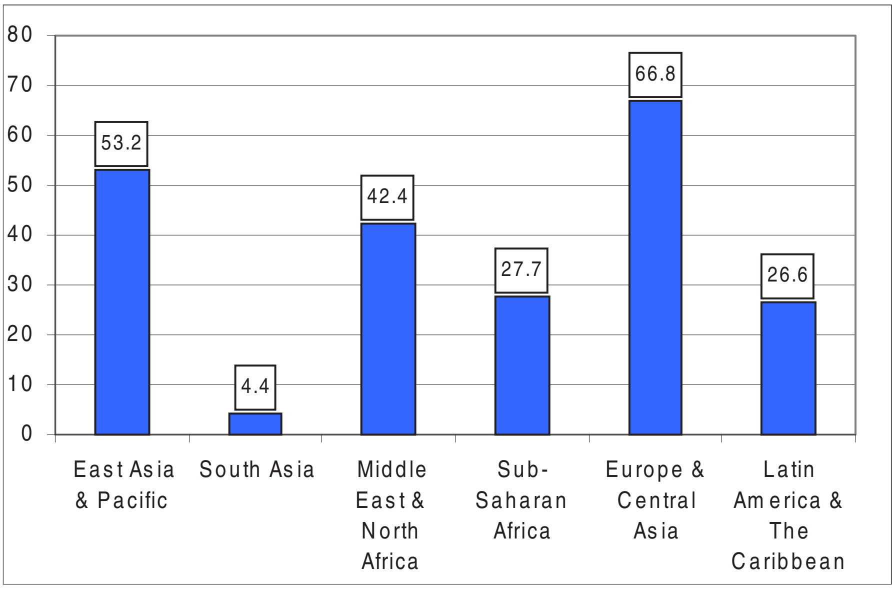
Sources: Global Development Finance 2000 and DFID 1999. 1. Growth rates used in the ***base scenario*** are drawn from the current projections of the Global Development Finance 2000. 2. Growth rates used in the ***poverty-reduction target scenario*** are drawn from DFID (1999).3. The growth rates used in 2002 are replicated for the years 2003-2009.

4.1. Base scenario[72]

The net external financing needs of each developing region, defined here by the amount of external resources to finance their current account deficits, vary considerably across regions, from US$ 4.4 billion a year in South Asia to US$ 66.8 billion a year in Europe & Central Asia. A considerable, though smaller, variation can be also observed when financing needs are measured as a proportion to the GDP. They range from 0.6 for South Asia to 5.8 for Middle East & North Africa.

72 It should be noted that, although similar, the total estimated values of financing needs derived from the simulations by income-groups and by regions are not the same. Given that the parameters used in the simulations by income-groups and regions are fully consistent, the difference is explained by the dynamics of the simulations. This problem could be solved by running simulations for each developing country rather than for groups of countries. This is however not feasible due to lack of data information.

FIGURE 3
External Financing Needs, 2000-2009 - base scenario
Annual average U$ 1998 billion



Source: Author's elaboration based on simulation's results (see table 5 and annex 2 for details).

Of the four major determinant factors of the current account balance, the two most important ones are the savings-investment gap and interest rates on external debt. For example, these factors respectively explain 75 percent and 22 percent of external financing needs of the Sub-Saharan region in the year 2002. The savings-investment gap is all the more important in explaining financing needs of regions like the Middle East & North Africa and Europe & Central Asia. In these regions the gap corresponds respectively to 118 percent and 90 percent of their financing needs in 2002. Its prominence is due to the regions' low efficiency of capital (especially in Europe & Central Asia) and relatively low savings rate (especially in the Middle East & North Africa).

South Asia fares rather well due to the fact that its savings-investment gap, though considerably high, is almost all offset by unilateral transfers, mostly in the form of workers' remittances. In the case of Latin America & The Caribbean, its financing needs are reasonably low on average (0.9 of their GDP), partly because of a current account surplus estimated for the initial years as a result of a predicted lower economic growth. Table 5 shows that financing needs will be high particularly for the Middle East & North Africa, and Europe & Central Asia because of their low levels of capital efficiency, and consequently the higher investment levels needed for meeting higher growth targets.

4.2. *Poverty-reduction target scenario*

In this scenario we estimate the net external financing required to halve extreme poverty by 2015 in each developing region of the world. It builds upon growth rate targets which are believed to be necessary (though not sufficient) to meet such poverty reduction target. Such growth rates take account of the degree to which poverty reduction responds to growth, and bear a strong correlation with levels of income inequality in each region. For example, it can be seen from table 5 that regions like Latin America and The Caribbean which are notably known for having highly unequal income distribution will need extremely high growth to reduce poverty, whereas the opposite applies to regions with better income distributions like Europe & Central Asia and (especially) East Asia & Pacific.

To calculate the external financing needs under the ***poverty-reduction target*** scenario, some of the parameters of the ***base scenario*** were modified, to keep consistency with the much higher growth rates required for the objective of halving poverty. If such changes were not made, the new projections of financing needs would be completely unrealistic.[73]

These changes are basically two, as follows. First, the average efficiency of capital is set to increase from the 6th year on (i.e. ICOR falls), a plausible hypothesis after a few years of resumed growth. This applies to all regions except South Asia, given that the ICOR being used for that region is already relatively low. To Sub-Saharan Africa and Latin America & The Caribbean, this applies right from the first year given that these two regions require particularly high growth rates to halve poverty by 2015, as can be seen from Table 6 (see detailed explanations in Annex 2).[74] In addition, for the latter two regions savings rates are adjusted upwards.

This is done in two steps, the first in year 2000 and the second from the sixth year on. The underlying rationale of this upward adjustment is that in these two regions the particularly high growth rates being projected are expected to induce a quick and sustained increase in the regions' savings levels (see details in Annex 2).[75] This correction addresses the endogenity problem regarding savings sensitivity to growth. It should be noted however that for this to happen favourable conditions for growth should be in place, otherwise additional external finance might result in higher consumption levels (thus leading to stagnant investment and lower savings) rather than higher investment and savings.

Even after such adjustments (intended to reduce the projected financing gaps), the external financing needs of Sub-Saharan Africa and Latin America & The Caribbean are significantly higher than in the ***base scenario*** (see table 4). The estimated external financing needs for Latin America are 6.2 percent of the region's GDP, and for Sub-Saharan Africa, 12.7 percent. In the initial three years – 2000-2002 – such needs are even higher – 9.6 percent and 16 percent of the regions' GDP, respectively. If we add to these latter figures principal repayments due estimate for 2000-2002 (as calculated above), then external needs go up to 12.7 percent and 17.7 percent.[76] These needs are such that reducing poverty solely through growth becomes an almost unattainable task.[77]

---

73 For example, the net external financing needs for Latin America & The Caribbean would be of an annual average of U$ 1.6 trillion, and for Sub-Saharan Africa, of U$ 248 billion. These values are set in 1998 prices.

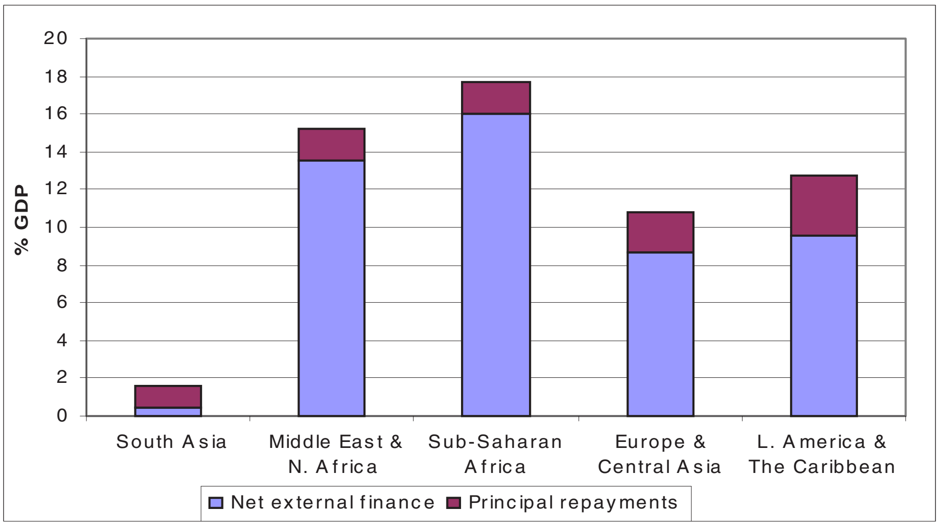
74 The ICOR is set to fall by 30%. For example, for Latin America & The Caribbean it falls from 4.67 (base scenario) to 3.27, and for Sub-Saharan Africa, from 5.96 (base scenario) to 4.17 (see annex 2).

75 It should be noted that for the purpose of reducing the financing gap, adjusting savings rates up is equivalent to using lower growth rates.

76 As noted before, such results are very sensitive to a change in parameters. If for Latin America & The Caribbean ICOR were reduced further down from 3.26 to 3.0, the external financing needs would be of US$ 126 billion rather than US$ 281 billion. In the Sub-Saharan Africa case, ICOR being reduced further down from 4.17 to 3.5 would result in external financing needs of about US$ 126 billion (rather than US$ 281 billion). However, although ICOR is expected to fall due to gains in efficiency, too a low ICOR is unlikely to be the case with economies supposedly running at full capacity (due to rapid and sustained growth) over a long period of time.

77 The view that growth alone will not be sufficient to reduce poverty, particularly in Africa, has been expressed previously, for example by Killick and White (1999), who reached such a conclusion based on a

FIGURE 4
External Finance 2000-2002 Poverty-reduction scenario
(% of GDP)



Source: Author's elaboration based on simulation's results (see table 5 and annex 2 for details) and Global Development Finance Country Tables 1999.

5. THE CHALLENGE TO REDUCE POVERTY

In the 1990s the only developing region that succeeded in reducing extreme poverty substantially was East Asia and the Pacific. In all other regions extreme poverty reduction was either just modest or hardly discernible (World Development Indicators 2000). Our projections indicate that for a marked poverty reduction to happen much higher growth and far larger amounts of external finance will be needed as compared to the levels observed in the 1990s.

However, as hinted above it is very unlikely that Sub-Saharan Africa and Latin America & The Caribbean will be able to reduce poverty in a dramatic way just through economic growth. In order to halve poverty by 2015 these two regions would have to experience 'dream growth rates' of 8.2 percent (Sub-Saharan Africa) and 10.2 percent (Latin America) over the next 15 years or so. Such rates are far above what these regions have ever managed to achieve. But even if this were economically feasible, it would require external financing needs on a continuous basis which far exceed even a very optimistic scenario of abundant (public and private) capital flowing from the North to the South.

For poverty to be reduced by the amount that has been targeted, a more inclusive growth strategy should be pursued, centred on tackling income distribution directly. The idea that a strategy that combines growth with better income distribution can have a greater result in terms of poverty reduction has been suggested in White and Anderson (2000). This idea challenges an old view that there is a trade off between these two major development objectives.

---

more comprehensive analysis in which it was highlighted the negative effects of a current trend of growing inequalities.

So far the focus has been on income poverty. However important tackling income poverty might be, the real target should be poverty broadly defined that has human well-being as its central dimension. This means going beyond the concerns of increasing the incomes of the poor and requires implementing and/or enhancing public policies and mechanisms that improve critical social indicators such as mortality rates and educational provision. Recurrent expenditure should play a key role in that process, but this also needs financing.

5.1. Complementary financing for recurrent expenditure

Recurrent expenditure can be related to the provision of a wide variety of goods and services, ranging from health services to current spending on civil service pay. It is broadly accepted that resources devoted to basic services are too few. For example, world-wide spending on public health is just 25 percent of what is set as a minimum requirement (World Development Report 1997). This provision gap is all the more acute in poor regions and poor countries.

Although the provision of public goods and services by very poor countries is too little relative to their needs, still such countries face chronic problems with financing their recurrent expenditure, given their extremely weak ability to raise public revenues. This implies negative public savings (see table 7), which combined with low savings levels by the private sector, is reflected in the low overall savings levels reported in table 1.

TABLE 7
Central Government Revenues and Expenditures – Selected Low-Income Countries, 1997
(% GDP)

	Total Current revenue (A)	Current expenditure (B)	Government savings (C) = (A)-(B)	Capital expenditure (D)	Overall surplus/deficit (+) (-) (E)=(C)-(D)
Burundi	13.7	17.3	-3.6	3.7	- 7.3
Cameroon	13.0	11.4	1.6	1.1	0.5
Ethiopia	17.1	18.1	-1.0	7.1	-8.1
Kenya	27.1	25.6	1.5	3.4	- 1.9
Myanmar	6.9	4.7	2.2	5.4	- 3.2
Pakistan	16.0	19.9	-3.9	2.8	- 6.7
Sierra Leone	10.5	13.4	-2.9	4.3	- 7.2
Zambia	18.6	14.3	4.3	7.1	- 2.8

Source: Author's elaboration based on data information from the World Development Report 1999/2000.

From Table 1 it can be also observed that in low-income countries investment levels did not pick up during the 1990s despite the resumption of capital flows, indicating that part of such flows was used to finance recurrent expenditure. Savings even slightly declined reinforcing that hypothesis. The low investment and savings rates in Sub-Saharan Africa – around 17 percent and at years being down to 14 percent (see Table 1) suggest that this might indeed have been the case, with external resources being directed to fill in budgetary gaps rather than to support investment projects.

In order to finance additional recurrent expenditure, the usually recommended measure is to raise private savings (which can then be taxed or borrowed) or increase consumption-based tax revenues. This may be a feasible strategy for middle-income countries in Latin America, and could even contribute to the objective of income redistribution. But for the majority of Sub-Saharan countries, which are extremely poor, there is no room for reducing private consumption. Therefore, recurrent expenditure should be financed with supplementary external resources.

BOX 2

How much relief can come through the HIPC initiative?

The HIPC initiative as currently designed can provide only little financing relief to the beneficiary countries. The initiative is aimed at bringing external debt to 'sustainable levels', but our projections for Sub-Saharan Africa region (which includes most of the eligible countries) show that even if all the external debt of Sub-Saharan countries were wiped out, this would imply, according to the ***base scenario***, a reduction of only 22 percent of the region's total net external financing needs in 2000, or less than 9 percent under the ***poverty-reduction target scenario***. However, although the macro impact is not substantial, still the initiative is potentially very important. This is because debt service by being (almost all) public and therefore part of the government budget, if reduced or eliminated it would probably release resources for recurrent expenditure in the social sector.

Given the potential benefits that recurrent expenditure can bring to poverty alleviation, in the absence of additional external finance it might be preferable to pursue moderate rather than intensive growth, as our projections suggest that the latter will require extremely high levels of external finance. This could free external resources for recurrent expenditure. From the savings-investment gap perspective, this means lower investment and savings levels, keeping the gap roughly constant.

BOX 3

Financing recurrent expenditure in Mozambique

Life expectancy, infant mortality and adult literacy are some of Mozambique's social indicators amongst the worst in Sub-Saharan Africa (Addison and de Souza, 1999). Recurrent expenditure in health and education between 1991 and 1995 – the immediate post-war reconstruction period – corresponded to 20 percent of total recurrent expenditure, the latter reaching in some years 50 percent of the country's GDP, against total government revenues of 20 percent (Pereira da Silva and Solimano, 1999). Most of the resulting fiscal gap was financed with external grants, but additional external financing will be needed to increase recurrent expenditure in the largely under-funded areas of basic health and primary education. According to some estimates, health spending should be doubled to rehabilitate rural clinics destroyed by the war (Addison and de Souza, 1999). Mozambique is one of the few countries that have already met the pre-conditions for debt relief under the HIPC initiative, but all projections indicate that the relief being envisaged under the current criteria is clearly insufficient to meet the country's daunting needs.

6. CONCLUDING REMARKS

This study shows that the external financing needs of developing countries far exceed the amounts of development financing flowing from the North to the South. In particular, it makes evident that halving poverty by 2015 only through economic growth is almost unattainable. This calls for a development strategy that combines growth with redistribution of income. In that strategy recurrent expenditure should play a key role. However, this may also need additional financing, as it is uncertain that resources freed by less intensive growth would be sufficient. Therefore, alternative solutions should be sought in order to increase the availability of external finance. This can be pursued for example by making effective the enhanced form of the HIPC initiative.

7. REFERENCES

Addison, T. and de Souza, C., 1999 'Mozambique: Economic Reform and Reconstruction'. In: McGillivray, M. and Morrissey, O., eds., *Evaluating Economic Liberalization: Case-Studies in Economic Development*, Vol. 4, MacMillan Press.

DFID, 1999 'Can a Billion People be Lifted out of Poverty? Economic Growth, Equity and Security', DFID, http://www.dfid.gov.uk/public/what/pdf/tsp-economic.pdf

Easterly, W., 1999 'The ghost of financing gap: testing the growth model used in the international financial institutions', *Journal of Development Economics*, Vol. 60, pp. 423-438.

Killick, T. and White, H., 1999 'Poverty in Africa: Why Economic Growth Will Not Be Enough', ODI, June. http://www.odi.org.uk/speeches/killick.html

Lensink, R. and Van Bergeijk, P. A. G., 1991 'Official Finance Requirements in the 1990s', *World Development*, Vol. 19, No 5, pp. 497-510.

Pereira da Silva, L. A. and Solimano, A., 1999 'The Transition and the Political Economy of African Socialist Countries at War (Angola and Mozambique)'. In: Paulson, J. A., ed., Economies in Transition, Vol. 2, MacMillan Press.

Selowsky, M. and Van Der Tak, H., 1986 'The Debt Problem and Growth', *World Development*, Vol. 14, No. 9, pp. 1107-1124.

White, H. and Anderson, E., 2000, 'Growth Versus Distribution: Does The Pattern of Growth Matter?', IDS, mimeo.

World Development Report 1997, World Bank.

Table F - 1: List of Countries (by Region and Income Group)

L and M within brackets stand for low-income and middle-income countries, respectively. The classification by regions and country income groups draw on Global Development Finance 1999.

East Asia & Pacific

Cambodia (L)
China (M)
Indonesia (M)
Korea, Rep. (M)
Malaysia (M)
Papua New Guinea (M)
Philippines (M)
Thailand (M)

South Asia

Bangladesh (L)
India (L)
Nepal (L)
Pakistan (L)
Sri Lanka (M)

Middle East & North Africa

Algeria (M)
Egypt, Arab Rep. (M)
Jordan (M)
Morocco (M)
Syrian Arab Republic (M)
Tunisia (M)
Yemen, Rep. (M)

Sub-Saharan Africa

Angola (L)
Benin (L)
Botswana (M)
Burkina Faso (L)
Burundi (L)
Cameron (L)
Cape Verde (M)
Central African Republic (L)
Comoros (L)
Congo, Dem. Rep. (L)
Congo, Rep. (L)
Cote d'Ivoire (L)
Equatorial Guinea (M)
Ethiopia (L)
Gabon (L)
Gambia (L)
Ghana (L)
Guinea (L)
Guinea-Bissau (L)
Kenya (L)
Lesotho (L)
Madagascar (L)
Malawi (L)
Mali (L)
Mauritania (L)
Mauritius (M)
Mozambique (L)
Namibia (M)

Niger (L)
Rwanda (L)
Sao Tome and Principe (L)
Senegal (L)
Seychelles (M)
South Africa (M)
Swaziland (M)
Togo (L)
Uganda (L)
Zambia (L)
Zimbabwe (L)

Europe & Central Asia

Armenia (L)
Belarus (M)
Bulgaria (M)
Czech Republic (M)
Estonia (M)
Georgia (M)
Hungary (M)
Kyrgyz Republic (L)
Latvia (M)
Lithuania (M)
Moldova (L)
Poland (M)
Romania (M)
Russian Federation (M)
Slovak Republic (M)
Turkey (M)
Ukraine (M)

Latin America & The Caribbean

Argentina (M)
Belize (M)
Bolivia (M)
Brazil (M)
Chile (M)
Colombia (M)
Costa Rica (M)
Dominica (M)
Dominican Republic (M)
Ecuador (M)
El Salvador (M)
Guatemala (M)
Haiti (L)
Honduras (L)
Jamaica (M)
Mexico (M)
Paraguay (M)
Peru (M)
Trinidad and Tobago (M)
Uruguay (M)
Venezuela (M)

Annex F - 2
The savings gap model and data sources

In order to estimate the net external financing needs of developing countries for 2000-2009 and 2000-2015, we rely on a savings gap model which draws on Lensink and Van Bergeijk (1991), and to a lesser extent, Selowsky and Van der Tak (1986). The model starts with a Harrod-Domar production function in which the investment rate required to meet a pre-determined growth rate is given by the incremental capital-output ratio.

$$i = y_t ICOR \qquad (1)$$

Where

ICOR = incremental capital-output ratio
i = investment rate
y_t = GDP growth

In the simulations we work with two scenarios, the first predicting growth rates drawn from current forecasts (base scenario) and the second based on growth rates which are believed to be necessary to halve extreme poverty by 2015 in each developing region of the world.

ICOR is the weighted average ratio of observed i and y of samples of countries (in each group of country and region) over the 1993-97 period for which such information is available (see list of countries in annex 1). Years of deep recession that tend to artificially inflate ICOR are left out.

Given growth and ICOR, we obtain the required level of investment. Investment can be financed with domestic and external resources. Regional domestic savings are obtained from weighted averages of savings rates over 1993-97 from countries for which information was available. Savings minus investment rates correspond to the savings gap. But if we consider national savings instead, which is domestic savings minus interest payments on external debt plus current transfers, then investment minus national savings will roughly correspond to the countries' current account balance, CA. In addition, by assuming that international reserves are held constant over time, then CA equals net external financing needs. If to that we further add profit remittances, we have:

$$NEF_t = (i - s)Y_t + PR_t + raD_t - UT_t \qquad (2)$$

Where

NEF = Net external financing needs.
Y_t = country's real GDP.
PR = profit remittances on foreign direct investment (FDI).
D_t = net external debt (gross external debt minus international reserves).
UT = unilateral transfer.
s= domestic savings rate
r= real interest rates.
a = parameter that indicates the proportion of non-concessional debt to total debt.

Net external debt is in turn determined as follows:

$Dt = D_{t-1} + bNEF_{t-1}$ (3)

Where b is 1 minus the ratio of foreign direct investment (FDI) to total external financing.

The two scenarios we work with are: the ***base scenario*** and ***poverty-reduction target scenario***. In all the two scenarios we have that:

- Y (base year) corresponds to GDP US$ 1998 values multiplied by 1999 growth rate forecast.
- All figures are in US$ 1998 prices. Inflation is ignored.
- a, the proportion of non-concessional debt to total debt, is set constant, according to the ratio of non-concessional debt to total debt stock in 1998. All non-concessional loans are assumed to bear market-based interest rates, whereas concessional loans bear no interest rates.
- b, the ratio of FDI to total net external financing, is set constant at 50% for all country groups and developing regions.
- PR in the base year corresponds to the ratio of profit remittance in 1998 to GDP 1998 multiplied by Y_t.
- UT is proxied by workers' remittances. It is used the ratio of workers' remittances in 1998 to GDP 1998 multiplied by Y_t.

Growth rates for low-income and middle-income countries are 5.0% in 2000, 5.3% in 2001 and 5.5% between 2001 and 2009. Growth rates for developing regions vary according to the scenarios, and are displayed in table 6 (see main text).

Real interest rates are set constant at 4%. Other 1998 values and parameters used in the simulations are:

	Y (base year) U$ billion 1998 values	ICOR	S	D (base year) U$ billion 1998 values	PR (base year) % GDP	A	UT (base year) % GDP
EA&P	1803407.1	4.46	0.37	419029.5	0.7	0.88	0.38
SA	597908.6	3.92	0.19	133412.8	0.058	0.51	2.38
ME&NA	592540.3	6.96	0.18	125083.5	0.26	0.71	2.14
SSA	342211.6	5.96	0.18	210933.7	1.26	0.61	0.99
E&CA	1013030.0	8.06	0.23	329523.8	0.18	0.89	0.63
LA&C	20280359.0	4.67	0.20	566117.5	0.76	0.92	0.53
LIC	857941.6	4.06	0.18	360404.2	0.22	0.55	2.1
MIC	5535967.9	5.30	0.27	1432381.2	0.62	0.89	0.67

EA&P: East Asia & Pacific; SA: South Asia; ME&NA: Middle East & North Africa; SSA: Sub-Saharan Africa; E&CA: Europe and Central Asia; LA&C: Latin America and The Caribbean; LIC: Low-income countries; MIC: Middle-income countries.

As mentioned in the text, in the ***poverty-reduction target scenario***, ICOR falls by 30% from the 6^{th} year on, given the expected gains in capital efficiency after a few years of sustained growth. This applies to all regions, except South Asia. To Sub-Saharan Africa and Latin America & The Caribbean, this applies right from the first year (that is, for these two regions ICOR falls from 5.96 to 4.17 and from 4.67 to 3.27, respectively). In addition, for the latter two regions savings rates are adjusted upwards. In the case of Sub-Saharan Africa, it initially moves from 0.18 to 0.20 point of the GDP, and from the sixth year on, from 0.20 to 0.25. In the case of Latin America & The Caribbean, it initially moves from 0.20 to 0.25 points of the GDP, and from the sixth year on, from 0.25 to 0.30. This upward adjustment is justified by the fact that savings are expected to pick up as investment increases to support higher growth.

Data sources:

Y (base year): World Development Indicators 2000 (p. 188) and Global Development Finance – Summary Tables 2000 (p. 11).
Y growth rate: Global Development Finance: Analysis and Summary Tables 2000 (p. 11 – ***base scenario***); DFID (1999), table 1, p. 16.
s: World Development Indicators CD-Room 2000.
D and PR: Global Development Finance: Country Tables 1999 (pp. 18-46).

ANNEX G

Developing Countries and Multilateral Development Banks in the Global Financial Architecture[78]

Impressive progress has been achieved in development and poverty reduction in the last fifty years. An important underlying cause of such progress has been due to the benefits of globalization, in its different dimensions.

However, globalization is highly problematic in two aspects. For many countries rapidly integrating into the global economy, there have in recent years been extremely high costs linked to large and developmentally disruptive currency and financial crises, which have often spread through contagion even to countries with fairly good macro-economic fundamentals. On the other hand, many countries and vast amounts of poor people have been excluded from globalization and its benefits. Trying to tackle these problematic aspects will not only help overcome challenges, but would also help avoid the risk of a backlash against globalization and its important benefits.

Recent crises have led to an important debate about a new international financial architecture, suited to this new period of globalization, and that can deal with the two main challenges outlined above. Firstly, the new financial architecture – and in particular, the international financial institutions – need to improve significantly crisis prevention, crisis management and speedy recovery after crises as well as more broadly facilitate access of developing countries to sustainable private flows. Secondly, it must help countries, especially but not only, the poorer ones, with the broader challenge of development, particularly as regards poverty reduction.

Though the international community as a whole clearly has an important interest in adapting the international financial system to achieve these aims – better crises prevention and management, sufficient and sustained flows to developing countries and, more broadly, sustained development – these objectives are absolutely central for developing countries themselves. It is, therefore, very crucial that developing countries' concerns and aims are properly represented at all the relevant fora, where important decisions are made. As the G-24 ministers stressed, at the 2000 Spring meetings, there is a 'concern about the increasing role being taken in international financial affairs by international forums in which the representation of developing countries is limited'. Furthermore, it is important that developing countries have a clear view on what they believe the shape of the international financial system should be.

The role of the International Financial Institutions (IFIs) needs to be adapted to ensure that they most effectively help developing and transition economies meet two major challenges: (a) Integrate into the world economic and financial system, in a way that they can maximize the benefits of globalization, while minimizing the costs. This implies,

[78] This attachment has been extracted from a paper by by Amar Bhattacharya and Stephany Griffith-Jones prepared as an background for the Conference on Developing Countries and the Global Financial Architecture, organised jointly by the Commonwealth Secretariat, the IMF and the World Bank, on 22-23 June 2000.

specifically, helping developing countries attract sufficient sustained private capital flows, whilst strengthening measures for crisis prevention and better crisis management, and (b) help developing countries, with the broader challenge of development, especially that of poverty reduction. This implies supporting policies and structural reforms that facilitate development, and helping countries secure sufficient external funding (both official and especially private) to sustain their growth and poverty reduction.

To fulfil, as best as possible, these two major roles, it is important to define: (a) the key tasks that need to be fulfilled by IFIs, (b) the mechanisms to be used (e.g. lending facilities), (c) at the division of labor between the IFIs as well as collaborative arrangements, and (d) appropriate governance of the IFIs, to include broader participation, especially, but not only, by developing countries.

As regards the key tasks that need to be met, it seems to us that these are:

1. Enhanced surveillance role, at the global, regional and country level. The nature of the surveillance must be deeper and broader than in the past, to reflect factors such as sharply increased externalities between countries, transmitted via phenomena such as contagion.

2. Financing role, which includes both provision of liquidity and longer-term, development finance. In both cases, the IFIs would fill gaps not covered by private markets (either because the private sector has temporarily withdrawn or because it is not willing to finance certain countries, sectors or projects); however, the role that the IFIs play should be such that they also facilitate or catalyze access to sustainable private flows. The conditionality linked to IFIs lending should not only support this catalytic role, but also more broadly support policies that facilitate crisis prevention, management and recovery, as well as particularly, long-term development.

3. Delivery of international public goods. There is growing consensus that an important new role for the international community, and the IFIs in particular, is to contribute towards the creation of international public goods, as well as to the reduction of public 'bads'. Probably the main international public good to be delivered is poverty reduction; this is so, both because of the fundamental importance of this aim and because individual countries may deliver less poverty reduction than is globally optimal. More specifically, in the context of this paper, we will focus on three central aspects of international public goods: a) development and assistance of implementation of international standards, both for countries and markets, b) development and support for implementation of rules and regulations, to be applied both nationally and internationally and c) knowledge dissemination.

What roles could the Multilateral Development Banks (MDBs) play in this regard? They would naturally fit into the second category, financing role, although they have increasingly been called to become involved in the third category of helping to deliver international public goods. However, it is first necessary to acknowledge that, with respect to development finance, doubtlessly, private capital flows can and should play not only an important, but hopefully a growing role. However, (1) there are clear and important market gaps in private lending and investing in developing countries, which can only be filled by multilateral bank lending and (2) there are also important circumstances where such multilateral lending can help catalyze additional developmentally valuable private flows, which would otherwise not take place. This is particularly true for low-income countries, but is also clearly relevant for middle-income countries, especially as in the latter, there is still a large proportion of the world's poor people. It is noteworthy that many private bankers and private institutional investors are themselves very aware of such limitations and welcome multilateral bank lending both to fill market gaps and to help catalyze new private flows.

As regards *market gaps*, the following seem the most important, and therefore the most relevant for being filled by MDB lending:

(a) Private lenders and investors tend to be unwilling to provide long-term financing, especially to developing countries;

(b) Private flows are often volatile and reversible, as shown in recent currency and financial crises;

(c) Private lenders and investors are less willing to channel resources to activities that are higher risk, but developmentally essential (such as lending to the financial sector especially but not only in times of, or just after, crises) or to activities where the social returns may especially in the short- to medium-term be higher than the private returns (such as health and education). Multilateral lending has, for example, been very valuable in providing both significant lending and technical assistance for the improvement and development of the financial sector to countries immediately after crises (e.g. South Korea in 1998; Mexico and Argentina, 1995). The private lenders would have considered lending to the financial sector in such circumstances as excessively risky.

Equally valuable has been post-crises multilateral lending to help fund social safety nets, in middle-income countries, crucial both to alleviate poverty and human suffering and to help provide political stability, essential for helping economic recovery. Again, the private lenders would not consider lending for social safety nets attractive, as social benefits would clearly outweigh private benefits. Extremely valuable has been lending and support for reform in social sectors, such as health and education.

(d) Private lenders and investors tend to be less willing to channel resources to smaller economies, given that entering economies has fairly high transaction costs for them. This is one factor, which would seem to explain why the share of multilateral to total external debt tends to be far higher in smaller than in larger countries.

As regards to the first point (a), - unwillingness to lend for long maturities - we will illustrate it with reference to market gaps or failures inherent in private investment in infrastructure.

i) Big infrastructure projects often take a long time to build up revenues and become profitable; these time periods are often far longer than those for which the international capital or insurance markets wish to lend for or insure against. Financial markets do not wish to commit themselves over very long periods, as they seem to perceive that risk increases over time.

ii) Even in certain developed economies (e.g. Greece or Portugal), but more so in middle-income countries and even more in low-income countries, domestic capital and financial markets are relatively under-developed, especially for long-term maturities, and country risk is seen as relatively higher than elsewhere, which means that shorter maturities are available. As domestic capital markets deepen and develop, this problem should be gradually overcome.

iii) Private lenders or investors will not benefit from externalities to projects, such as increases to welfare provided by positive environmental implications of certain projects or by additional external positive economic effects captured by other private economic agents, that are not reflected directly in income to the infrastructure project.

As regards to the second point (b), private lending to middle-income countries tends to have an average significantly shorter maturities than does official lending, mainly corresponding to multilateral bank lending. (Table G-1)

TABLE G-1
Average Maturity (in years) of New Commitments for Middle-Income Countries

	1970	1980	1990	1995	1998
Official creditors	24.5	20.1	19.7	16.7	15.0
Private creditors	9.6	9.8	13.8	7.4	8.9

Source: World Bank, *Global Development Finance Report*, Washington DC, 2000

Furthermore, a very large proportion of bank lending to developing countries is very short-term – less than one year. According to BIS data, in mid-1999, the proportion of short-term lending to total bank lending for all developing countries was 49.6 per cent, proportion that had been even higher in the previous years.

As a result, any large shift from official to private sector borrowing would significantly decrease the average maturity of the debt of these countries, which would increase substantially the risk of volatility and reversibility of such flows; such volatility and reversibility is widely recognized as one of the main factor causing recent very developmentally costly financial and currency crises. These crises have occurred not only in countries with underlying weaknesses in their economic policies and/or in their financial sectors, but also in countries where these domestic elements are fairly positive, but their capital market access is hurt by contagion or by other external shocks, such as deterioration of their terms of trade.

Not only is multilateral lending more long-term, it also tends to be counter-cyclical. There is indeed clear evidence, for example, during the debt crises of the 1980's in Latin America, that World Bank lending increased quite significantly as private flows fell sharply, thus helping compensate the contractionary effects on the economy of the large falls in private lending.

Multilateral lending steps in to fill important market gaps, but also, of equal importance, is its *catalytic role in encouraging additional private flows*, especially to countries (e.g. after crises), or sectors, (e.g. infrastructure), with limited access to private finance varied mechanisms can be used for achieving this purpose, including co-financing and guarantees, as well as new mechanisms such as extending preferred creditors transactions. Guarantee mechanisms need to be carefully designed, so that they only cover those risks which the markets themselves are unwilling on their own to cover, this will lead to additionally of flows. Both multilateral lending and guarantees should only be given when projects have been carefully evaluated, and they are economically viable.

Not only the World Bank and the regional development banks - but also particularly the IFC, MIGA and their equivalents in the regional banks - seem to clearly play on important catalytic roles in attracting additional private flows to emerging markets. Through different mechanisms, they help attract private flows to countries, sectors and individual private borrowers that would probably otherwise not receive them, they help widen the range of private investors and lenders, to include, for example institutional investors such as pension funds and they help achieve longer maturities (either by the general comfort they provide or by specific mechanisms, such as guaranteeing or lending for the later maturities within a specific loan). Private lenders and investors clearly appreciate and value this catalytic role.

Naturally, the modalities used by the MDBs to help catalyze private flows need to be reviewed and evaluated carefully, so that relevant modifications improvements and updating can be introduced to maximize their development impact and minimize any problematic effects. However, this is very different from the Meltzer 2000 proposals, that include abolishing the IFC, MIGA and eventually eliminating the World Bank's lending and catalytic role, both to middle-income countries and to poor countries with market access. Following these recommendations of the Meltzer Report (see Table E-1 of Annex) would have extremely negative consequences on the development prospects of the countries in which the majority of the world's poorest people live.

As in the case of liquidity provision, also in the case of development finance, lending needs to be accompanied by appropriate conditionality. It seems desirable that the conditionality of development lending moves from a predominant focus on macro-economic issues to more clearly emphasizing the nature of human needs; this is a challenging task. A second important challenge is to assist governments (through conditionality, technical assistance and other mechanisms) to move towards policies that are more likely to encourage growth and poverty reduction. Thirdly, it is important to design better procedures for interaction between countries and development banks; this includes the need for a smaller number of conditions, and clear performance targets, which should be set realistically which makes them easier to implement.

ANNEX H

Acronyms & Abbreviations

AfDB	African Development Bank
AfDF	African Development Fund
AFESD	Arab Fund for Economic and Social Development
AIDS	Acquired Immune Deficiency Syndrome
AsDB	Asian Development Bank
AsDF	Asian Development Fund
BADEA	Arab-African Development Bank
BOAD	West African Development Bank
CABEI	Central American Bank for Economic Integration
CAF	Corporación Andina de Fomento
CDB	Caribbean Development Bank
CDF	Comprehensive Development Framework
CDM	Clean Development Mechanism
CER	Certified Emissions Reductions
CGIAR	Consultative Group of International Agricultural Research
DAC	Development Assistance Committee of the OECD
E/L ratio	Equity to Loan ratio
EADB	East African Development Bank
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
FSL	Fixed-Spread Loans
FSO	Fund for Special Operations
FY	Fiscal Year
G-7	Group of Seven Summit Countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States)
GAO	US General Accounting Office
GAVI	Global Alliance for Vaccines and Immunization
GDP	Gross Domestic Product
GNP	Gross National Product
GDI	Gross Domestic Investment
GDS	Gross Domestic Saving
HD	Human Development
HIPCs	Highly Indebted Poor Countries

IADB	Inter-American Development Bank
IBRD	International Bank for Reconstruction and Development
ICOR	Incremental Capital – Output Ratio
ICSID	International Center for the Settlement of Investment Disputes
IDA	International Development Association
IDB	Islamic Development Bank
IFAD	International Fund for Agricultural and Rural Development
IFC	International Finance Corporation
IFI	International Financial Institution
IIC	Inter-American Finance Corporation
IMF	International Monetary Fund
IPCC	International Panel on Climate Change
LIBOR	London Inter-Bank Offer Rate
MDBs	Multilateral Development Banks
MIGA	Multilateral Investment Guarantee Agency
NADB	North American Development Bank
NDF	Nordic Development Fund
NGOs	Non-Governmental Organizations
NIB	Nordic Investment Bank
NICs	Newly Industrialized Countries
OCR	Ordinary Capital Resources
ODA	Official Development Assistance (colloquially called aid) referring to any financial transfers involving governments with a grant element of at least 25 percent
ODF	Official Development Finance
OECD	Organization for Economic Co-operation & Development (which comprises 23 developed country members as well as Mexico and Turkey)
PRSPs	Poverty Reduction Strategy Papers
SAL	Structural Adjustment Loan
TA	Technical Assistance
TNC	Transnational Corporation
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
US	United States of America
VRSC	Variable Rate Single Currency
WDR	World Development Report
WHO	World Health Organization

ANNEX I

List of Definitions Related to Financial Flows

Aggregate net resource flows	The sum of net resource flows on long-term debt (excluding IMF) plus net direct foreign investment, portfolio equity flows and official grants (excluding technical cooperation). Net flows (or net lending or net disbursements) are disbursements minus principal repayments.
Aggregate net transfers	Equal to aggregate net resource flows minus interest payments on long-term loans and foreign direct investment profits.
Aid	The words 'aid' and 'assistance' refers to flows which qualify as Official Development Assistance (ODA) or Official Aid.
Amortization	Repayments of principal on a loan. Does not include interest payments.
Bilateral debt	Includes loans from governments and their agencies (including central banks), loans from autonomous bodies, and direct loans from official export credit agencies.
Commitment	A firm obligation, expressed in writing and backed by the necessary funds, undertaken by an official donor to provide specified assistance to a recipient country or a multilateral organization. Bilateral commitments are recorded in the full amount of expected transfer, irrespective of the time required for the completion of disbursements. Commitments to multilateral development organizations are reported as the sum of a) any disbursements in the year in question which have not previously been notified as commitments and b) expected disbursements in the following year.
Concessional debt	Defined as loans with an original grant element of 25 percent or more, according to the Development Assistance Committee (DAC)of the OECD. The grant equivalent of a loan is its commitment (present) value, less the discounted present value of its contractual debt service; conventionally, future service payments are discounted at 10 percent. The grant element of a loan is the grant equivalent expressed as a percentage of the amount committed. It is used as a measure of the overall cost of borrowing.
Debt forgiveness or reduction	Shows the change in debt stock due to debt forgiveness or reduction. It is derived by subtracting debt forgiven and debt stock reduction from debt buyback.
Disbursements	Drawings on loan commitments during the year specified.
Disbursements on long-term debt	Drawings on loan commitments during the year specified. Long-term external debt is defined as debt that has an original or extended maturity of more than one year and that is owed to nonresidents and repayable in foreign currency, goods, or services.
Export credits	Loans for the purpose of trade and which are not represented by a negotiable instrument. They may be extended by the official or the private sector. If extended by the private sector, they may be supported by official guarantees.
Foreign direct investment net inflows	Shows the net change in foreign investment in the reporting country. Foreign direct investment is defined as investment that is made to acquire a lasting management interest (usually of 10 percent of voting stock) in an enterprise operating in a country other than that of the investor (defined according to residency), the investor's purpose being an effective

	voice in the management of the enterprise. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments.
Grant Element	Reflects the financial terms of a commitment: interest rates, maturity and grace period (interval to first repayment of capital). It measures the concessionality of a loan, expressed as the percentage by which the present value of the expected stream of repayments falls short of the repayments that would have been generated at a given reference rate of interest. Thus the grant element is nil for a loan carrying an interest rate of 10 percent; it is 100 percent for a grant; and it lies between these two limits for a loan at less than 10 percent interest. If the face value of the loan is multiplied by its grant element, the result is referred to as the 'grant equivalent' of that loan
Grants	Legally binding commitments that obligate a specific value of funds available for disbursement for which there is no repayment requirement.
Interest payments (LINT)	Actual amounts of interest paid in foreign currency, goods, or services in the year specified.
Loans	Transfers of which repayment is required.
Long-term debt outstanding and disbursed (LDOD)	Total outstanding long-term debt at year end.
Long-term debt service payments	The sum of principal repayments and interest payments in the year specified.
Long-term external debt	Debt that has an original or extended maturity of more than one year and that is owed to nonresidents and repayable in foreign currency, goods, or services. Long-term debt has three components: public debt, which is an external obligation of a public debtor, including the national government, a political subdivision (or an agency of either), and autonomous public bodies; publicly guaranteed debt, which is an external obligation of a private debtor that is guaranteed for repayment by a public entity; private nonguaranteed external debt, which is an external obligation of a private debtor that is not guaranteed for repayment by a public entity. Public and publicly guaranteed long-term debt are aggregated.
Maturity	The date at which the final repayment of a loan is due; by extension, a measure of the scheduled life of a loan.
Net flows	Disbursements minus principal repayments.
Net transfers	Net flows minus interest payments (or disbursements minus total debt service payments).
Official Aid	Flows which meet the conditions of eligibility for inclusion in Official Development Assistance
Official Development Assistance (ODA)	Grants or loans to countries undertaken by the official sector; with promotion of economic development and welfare as the main objective; at concessional financial terms (if a loan having a grant element of at least 25 percent). In addition to financial flows, technical cooperation is included. Grants, loans for military purposes are excluded
Official Development Finance (ODF)	Used in measuring the inflow of resources to recipient countries: includes a) bilateral ODA, b) grants and concessional and non concessional development lending by multilateral financial institutions, and c) Other Official Flows which are considered developmental (including refinancing loans) which have too low a Grant Element to qualify as ODA.

Official net resource flows	The sum of official net flows on long-term debt to official creditors (excluding IMF) plus official grants (excluding technical cooperation). Net flows (or net lending or net disbursements) are disbursements minus principal repayments.
Official net transfers	Equal to official net resource flows minus official interest payments on long-term loans.
Portfolio equity flows	The sum of country funds, depository receipts (American or global), and direct purchases of shares by foreign investors.
Private flows	Consist of flows at market terms financed out of private sector resources
Private net resource flows	The sum of net flows on debt to private creditors plus net direct foreign investment and portfolio equity flows. Net flows (or net lending or net disbursements) are disbursements minus principal repayments.
Private net transfers	Equal to private net resource flows minus private interest payments on long-term loans and foreign direct investment profits.
Public and publicly guaranteed multilateral loans	Include loans and credits from the World Bank, regional development banks, and other multilateral and intergovernmental agencies. Excluded are loans from funds administered by an international organization on behalf of a single donor government
Short-term loans	Loans with a maturity of less than one year.
Technical cooperation grants	Include free-standing technical cooperation grants, which are intended to finance the transfer of technical and managerial skills or of technology for the purpose of building up general national capacity without reference to any specific investment projects; and investment- related technical cooperation grants, which are provided to strengthen the capacity to execute specific investment projects.

ANNEX J

List of Persons Interviewed

Name	Position	Institution
Beileh, Abdirahman	Division Manager, Operations Policies and Procedures	AfDB
Bobb, Euric	Chief of the Office of the Presidency	IADB
Boucher, Chanel	Vice-President, Corporate Management	AfDB
Boyd, John	Senior Sector Specialist	AsDB
Brandt, Anna	Alternate Executive Directors	World Bank
Colby, Michael	Senior Officer, Environmental matters for the MDBs	US Treasury Department
DePlaa, Angelique	Economist, Liaison with MDBs, HIPC Management Unit	World Bank
Djibril, Daillo	Senior Cooperation Officer, Cooperation Unit	AfDB
Domingo, Hinahon	Financial Policy Unit of the ADB Treasurer's Department	AsDB
Elegbe, Bola	Principal Human Resources Officer	AfDB
Ernst, Mario	Director, Budgeting and Financial Policy Planning Department	AfDB
Evans, Warren	Manager of the Environment Division – Office of Environment and Social Development	AsDB
Faint, Tony	Director, International Division	DFID (U.K.)
Hatashima, Hiroyuki	Senior Risk Officer, Risk Management Unit	AfDB
Hopper, David	Former Senior Vice-President	World Bank
Huimasalo, Taisto	Executive Director	AfDB
Iglesias, Enrique	President	IADB
Iwasaki, Yoshiro	Director of Programs Department (West)	AsDB
Jalal, Kazi	Chief of the Environment and Social Development Department	AsDB
Johnsson, Erik	Alternate Executive Director for Canada, Denmark, Finland, the Netherlands, Norway and Sweden	AsDB
Kalumba, Katele	Minister	Ministry of Finance and Economic Development Zambia

Karlsson, Mats	Vice-President for External and UN Affairs	World Bank
Kock, Trevor de	Division Manager, Financial technical Services, Treasury Department	AfDB
Lamb, Geoffrey	Director, Resource Mobilisation	World Bank
Le Pape, Jacques	Head of ODA and MDB's Division, Treasury Department	Ministere de l'Economie, des Finances et du Budget, France
Lintjer, John	Vice-President for Finance and Administration	AsDB
Lizano, Eduardo	President of the Central Bank of Costa Rica	Costa Rica
Lockhart, John	Executive Director for Australia, Azerbaijan, Cambodia, Hong Kong, China, Kiribati, Federated States of Micronesia, Nauru, Solomon Islands, Tuvalu	AsDB
MacAllister, Elisabeth	External Affairs and UN vice presidency	World Bank
Madawi, Mervat	Technical Operations Manager	Arab Development Fund
Malhotra, Kamal	Senior Adviser	UNDP
Manai, Mohamed	Chief Evaluation officer, Operations Evaluation Department	AfDB
Martin, Kris	External Affairs and UN vice presidency	World Bank
Mashayeki-Beschloss, Afsaneh	Treasurer	World Bank
Murray, Bruce	Officer in charge of the Programs Department (Region East) and recently appointed Resident Representative of the AsDB in China.	AsDB
Ndoumbe, Issac Lobe	Private Sector Department	AfDB
Nishimoto, Shoji	Director of the Strategy and Policy Department	AsDB
Njie, Sulayman	Policies Officer, Human resources Management Dept.	AfDB
Nuñez de Reyes, Gabriela	Minister of Finance	Ministry of Finance, Honduras
Pascual, Alfredo	Head of the Project Finance I Private Sector Group	AsDB

Payne, Julian	Dean of the ADB Board and Executive Director for Canada, Denmark, Finland, the Netherlands, Norway and Sweden	AsDB
Perry, Guillermo	Chief Economic Director – Poverty Reduction and Economic Management (Latin America and the Caribbean Region)	World Bank
Peterson, Mirja	Alternate Executive Directors	IADB
Picciotto, Robert	Director of the Operations Evaluation Department	World Bank
Potten, David	Business Development Manager, World Bank Institute	World Bank
Quick, Stephen	Director of Office of Evaluation and Oversight	World Bank
Richardson-Golinski, Ulrika	Sweden/Denmark Program Coordinator, Cooperation Unit	AfDB
Rischard, Jean-Francois	Vice-President for Europe	World Bank
Rivera, Ivan	Alternate Executive Director for Peru and other Latin American countries	World Bank
Rychner, Daniel	Counsellor, Embassy of Switzerland	AfDB
Saborio, Sylvia	Senior Researcher	Overseas Development Council (ODC)
Santa Anna, Filomeno	Head of the liaison committee with the WB	Action for Economic Reforms – University of the Philippines
Schamis, Graciela	Advisor Office of the Presidency	IADB
Schuerch, William	Undersecretary of the Treasury for International Financial Institutions	US Treasury Department
Shakow, Alex	Secretary of the Development Committee	World Bank
Short, Claire	Secretary of State	Department for International Development , UK
Sicam, Paulynn	Editor of Cyberdyario (a web-based newspaper in Manila).	NGOs
Songo, Dan	Head of Coalition of Philippine NGOs	NGOs
Thomas, Patrick	France	AsDB
Tumesiime-Mutebile, Emmanuel	Permanent Secretary/ Minister of Finance	Planning & Economic Development Uganda
Verbiest, Jean-Pierre	Manager of the Strategic Planning and Coordination Division	AsDB

Vives, Antonio	Deputy Manager – Infrastructure, Financial Markets and Private Enterprise, Sustainable Development Department	IADB
Vusi, T.I.S.	Manager, Financial Policy Planning Division	AfDB
Vyas, Yogesh	Chief Environmentalist, Environment and Sustainable Development Unit	AfDB
Watkins, Alfred	In charge of guarantee schemes for the Soviet Union and other countries.	World Bank
Webb, Richard	President of the Board of Directors – Banco Latino	Peru
Xiaoyu, Zhao	Executive Director for China	AsDB
Yagi, Ken	Deputy Director General International Financial Institutions, Minister of Finance, Japan	Ministry of Finance, Japan
Yoon,Jeung-Hyun	Executive Director	AsDB
Zoukpo, Raymond	Chief Officer, Risk Management Unit	AfDB

SELECTED BIBLIOGRAPHY

NOTE: A vast array of material (statistical tables, working policy papers) internal to the MDBs was extensively consulted as part of this study. These materials are not referenced in the following bibliography which refers only to a selection of the principal published materials that were consulted.

Addison, T. and de Souza, C., 1999, 'Mozambique: Economic Reform and Reconstruction', in McGillivray, M. and Morrissey, O., eds., *Evaluating Economic Liberalization: Case-Studies in Economic Development*, Vol. 4, MacMillan Press.

African Development Bank, 1999, *Annual Report 1999,* Abidjan, Côte d'Ivoire.

Akyuz Y. and Cornford A, 1999, 'Capital flows to developing countries and the reform of the international financial system'. Paper prepared as part of the WIDER Project, New Roles and Functions for the UN and the Bretton Woods Institutions, UNCTAD, Discussion Paper No. 143, Geneva, Switzerland.

Akyuz, Y., & Gore, C.G., 1996, 'The investment-profits nexus in East Asian Industrialization', *World Development*, 24 (3) 461-470.

Akyuz, Yilmaz and Andrew Cornford, 1999. 'Capital flows to developing countries and the reform of the international financial system', UNCTAD Discussion Paper No. 143, November.

Akyuz, Yilmaz, 2000. 'The debate on the International Financial Architecture: Reforming the Reformers'. UNCTAD Discussion Papers No. 148.

Asian Development Bank, 1999, *Annual Report 1999*, Manila, Philippines.

Asian Development Bank, 2000. 'Long Term Strategic Framework for the Asian Development Bank', Background Materials, Strategy, Planning & Policy Coordination Division, June.

Bank of International Settlements, 1999 *Annual Report 1999*, Basle, Switzerland.

Bauer, Peter, 1998. 'Development Aid: End it or Mend it', Occasional Papers No. 43, International Center for Economic Growth, San Francisco.

Bergsten, Fred, Richard Huber, Jerome Levinson, and Esteban Edward Torres, 1999. Dissenting Statement (Meltzer Report).

Brajovic-Bratanovic, Sonja, 1990. 'International Financial Markets and the LDC Prospects', Main Report Prepared for the Strategic Planning Division, Strategic Planning and Review Department, World Bank, Washington, D.C, USA .

Cailloux, Jacques and Stephany Griffith-Jones, 1999. 'International Bank Lending and the East Asian Crisis', IDS, University of Sussex, Brighton, U.K.

Cailloux, Jacques and Stephany Griffith-Jones, 1999. *Global capital flows to East Asia, surges and reversals* IDS, University of Sussex, Brighton, U.K.

Center for Strategic and International Studies (CSIS) 1998. *The United States and the Multilateral Development Banks*: *A Report of the CSIS Task Force on the Multilateral Development Banks*, Washington DC, USA.

Cordell, Arthur J.1997. 'Taxing the Internet: The Proposal for a Bit Tax', speech delivered to the International Tax Program at the Harvard Law School, February 14.

Cornford, Andrew, 1995. 'The Tobin Tax: Silver Bullet for Financial Volatility, Global Cash Cow or Both?' UNCTAD /SGO/10, 1995.

Culpeper, Roy, 1997, *Multilateral Development Banks Titans and Behemoth?*, Vol. No 5, The North South Institute, , Ottawa, Canada.

Culpeper, Roy, 1994, *Canada and the Global Governors: Reforming the Multilateral Development Banks*, The North-South Institute, Ottawa, Canada.

Corporación Andina de Fomento (CAF), 1999. *Annual Report 1999*, Caracas, Venezuela.

Development Assistance Committee (DAC) 1998. *Development Co-operation 1998*, OECD, Paris, France.

Development Assistance Committee (DAC), 1996. *Development Co-operation 1996*, OECD, Paris, France.

Development Assistance Committee (DAC), 1995. *Development Co-operation 1995*. OECD, Paris, France.

Development Committee, 1996. *Serving a Changing world, Report of the Task Force on Multilateral Development Banks*, The World Bank/International Monetary Fund, Washington DC, USA.

Development Committee, 2000. 'Poverty Reduction and Global Public Goods: Issues for the World Bank in Supporting Global Collective Action', DC/2000-16, Washington, D.C., USA

Development Today, Nordic Outlook on Development Assistance, Business & the Environment, 2000. 'In spite of warning from Norwegian UN Delegation against large-scale funding of GAVI, PM Stoltenberg pledges NOK 1 b', Vollen, Norway

DFID, 1999. 'Can a Billion People be Lifted out of Poverty?' Economic Growth, Equity and Security', DFID, http://www.dfid.gov.uk/public/what/pdf/tsp-economic.pdf

Easterly, W., 1999. 'The ghost of financing gap: testing the growth model used in the international financial institutions', *Journal of Development Economics*, Vol. 60, pp. 423-438.

Eccles, Stephen and Gwin, Catherine, 1999. 'Supporting Effective aid: A framework for future concessional funding of multilateral development banks', *Overseas Development Council (ODC) Policy Essay N° 23.*

Edwards, Michael, 1999. *Future positive: International Co-operation in the 21st Century,* Earthscan Publications, London, UK.

European Commission, 1996. 'Building the European Information Society for Us All', First Reflections of the High Level Group of Experts, Final Policy Report Directorate-General for Employment Industrial Relations and Social Affairs DG V, Brussels, January. Taken from the website: www.ispo.cec.be.

European Investment Bank, 1998. *International financial institutions in the 21st Century,* Cashiers Papers, Luxembourg.

European Union, 1997, 'A European Initiative in Electronic Commerce', Communication to the European Parliament, the Council, the Economic and Social Committee and the

Committee of the Regions. COM(97)157. Taken from the website: www.cordis.lu-esprit-src-ecomcom3.html.

Federation of Electronic Industries, 1996. 'Bit Tax Proposal'. FEI Position Paper, (Ref ICT/96/1564) November. Taken from the website: www. fei.org.uk.

Feinberg, Richard, and contributors, 1986. *Between two worlds: The World Bank's Next decade, US-Third World policy perspectives n° 7,* Overseas Development Council (ODC).

Gamble, Andrew, 1999. Debate: 'The Regulation of Global Finance'. *New Political Economy*, Vol. 4, No. 3.

Girvan, Norman, 1999, 'A perspective from the South', *New Political Economy*, Vol. 4, No. 3.

Griffith-Jones, Stephany, 2000, 'Towards a Better Financial Architecture', *Journal of Human Development*, Vol. 1, No. 1.

Griffith-Jones, Stephany, 2000, 'International Capital Flows to Latin America', *Serie Reformas Económicas 55 ECLAC.*

Griffith-Jones, Stephany and José Antonio Ocampo, 1999. *The Poorest Countries and the Emerging International Financial Architecture*, Expert Group on Development Issues 1994:4.

Griffith-Jones, Stephany 1999. 'The case for a role for multilateral development banks in Middle-income countries: a reply to Meltzer', Draft, Institute of Development Studies, University of Sussex, Brighton, UK.

Griffith-Jones, Stephany, 1999, 'Identifying needs and filling gaps', *New Political Economy*, Vol. 4, No. 3, 1999.

Griffith-Jones, Stephany , 'International Capital Flows and their Management', Paper No. 13 UNDP Taken from web site www.iigov.org/pnud.

Griffith-Jones, Stephany, Hans Singer, Alicia Puyana, and Christopher Stevens, 1994. *Assessment of the IDB Lending Programme, 1979-92*, Institute of Development Studies (IDS), University of Sussex, Brighton, UK.

Hankcock, Graham, 1992. *Lords of poverty: the power, prestige, and corruption of the international aid business,* The Atlantic Monthly Press, New York, USA.

Institute of Development Studies, (IDS), 2000, 'Poverty Reduction Strategies: A part for the Poor?', *Policy Briefing* Issue 13, April, Institute of Development Studies, University of Sussex, Brighton, UK.

Inter-American Development Bank, 1999. *Annual Report 1999,* Washington DC, USA.

Inter-American Development Bank, 1997, 'Renewing the Commitment to Development: Report of the Working Group on the Institutional Strategy', IADB, August, Washington, DC, USA

Inter-American Investment Corporation, 1999, *Annual Report 1999*, IADB, Washington DC, USA.

International Financial Corporation, 1999, *Annual Report 1999*, World Bank, Washington, D.C., USA.

Kanbur, Ravi, Todd Sandler, and Kevin M. Morrison, 1999, *The Future of Development Assistance: Common Pools and International Public Goods*, Policy Essay No. 25, Overseas Development Council, Washington, D.C. USA.

Kaul, Inge, Isabelle Grunberg, and Marc A. Stern, 1999, *Global Public Goods: International Cooperation in the 21st Century*, UNDP, New York, USA.

Kim, Yoonmai, 2000, 'Causes of capital flows in developing countries', *Journal of International Money and Finance,* 19 (2000) 235-253.

Klein, Michael, 1998, 'One hundred years after Bretton Woods: A future history of the World Bank Group', *European Investment Bank Papers*, Volume 3 (1998), No. 2, pp. 31-58.

Knight, Michael, 1998. 'Developing Countries and the Globalization of Financial Markets', *World Development,* Volume 26, Issue 7, July.

Lensink, R. and Van Bergeijk, P. A. G., 1991 'Official Finance Requirements in the 1990s', *World Development*, Vol. 19, No 5, pp. 497-510.

Lensink, Robert, and Howard White, 1998, 'Does the Revival of International Private Capital Flows Mean the End of Aid?: An Analysis of Developing Countries. Access to Private Capital', *World Development* Vol. 23 (8) pp. *1221-1234.*

Meltzer, Allan (Chairman), 2000, *Report of the International Financial Institution Advisory Commission*, US Congress, Washington DC.

Miller, R.(ed.), 1992, *Aid as peacemaker*, Carleton University Press Ottawa, ON, Canada.

Mistry, Percy and Paul Thyness, 1990, *Financing the multilateral system: Options for funding the UN system and the development banks,* Report No 13, Nordic UN Project, Stockholm, Sweden.

Mistry, Percy, 1995, *Multilateral Development Bank: An assessment of their financial structures*, *policies and practices*, FONDAD, The Hague, Netherlands.

Mohammed, Faez, 1997. 'The role of Islamic Development Bank in Strengthening Regional Organization', *Iranian Journal of International Affairs*, Vol. IX, No. 3.

Nordic Development Fund, 1999, *Annual Report 1999*, Helsinki, Finland.

Ohlin, Goran, 1994, 'The negative net transfers of the World Bank'. Proceedings of the UNCTAD Conference on the International Monetary and Financial System: Developing Country Perspectives, Cartagena, Colombia 18-20 April, United Nations Conferences on Trade and Development, New York.

Pereira da Silva, L. A. and Solimano, A., 1999 'The Transition and the Political Economy of African Socialist Countries at War (Angola and Mozambique)', in Paulson, J. A., ed., *Economies in Transition*, Vol. 2, MacMillan Press.

Rana, Pradumna B. 1998, 'Surges and volatility of private capital flows to Asian developing countries: implications for Multilateral Development Banks', Institute of Development Studies, Information Resource Unit, University of Sussex, Brighton, UK.

Reinicke H., Wolfgang, Francis Deng, Jan Martin Witte, Thosten Benner, Beth Whitaker, and John Gershman, 1999, *Critical Choices: The United Nations, Networks, and the Future of Global Governance*, International Development Research Centre, Ottawa, Canada.

Richardson, Richard W., Jonas Haraiz, 1995, *Moving to the Market: The World Bank in Transition*, Policy Essay No. 17, Overseas Development Council, Washington, DC, USA.

Rischard, Jean-François, 1998. 'Multilateral development banks and global public networks: Speculations for the next century', European Investment Bank Papers, Volume 3 (1998), No. 2, pp. 82-89.

Sagasti, Francisco and Gonzalo Alcalde, 1999. *Development Cooperation in a Fractured Global Order: An Arduous Transition,* International Development Research Center, Ottawa, Canada.

Sagasti, Francisco, 1999. 'The Shape of Things to Come: Development Cooperation in the 21st Century' in *Cooperation South: Partnerships for Development*, UNDP, Number Two, December, New York, USA.

Sanford, J.1997. 'Alternative ways to fund the International Development Association (IDA)', *World Development*, 25 (3), 297-310.

Schmidt, Rodney, 1995, 'Feasibility of the Tobin Tax' by International Economic Analysts (Canadian Department of Finance). "DRAFT" (hand-written on the original paper - Note of the Transcriber), January 19.

Selowsky, M., and Van Der Tak, H., 1986, 'The Debt Problem and Growth', *World Development*, Vol. 14, No. 9, pp. 1107-1124.

Singh, Kavaljit, 1999 'Tobin Tax: An Idea Whose Time Has Come', article taken from the website: www.ased.org/resources/global/articles/singh9.htm.

Soete, Luc and Karin Kamp, 1996, 'The 'BIT TAX': the case for further research', University of Maastricht.

Stiglitz, Joseph E., 1998, 'International Financial Institutions and the provision of international public goods', European Investment Bank Papers, Volume 3 (1998), No. 2, pp. 116-133.

Stiglitz, Joseph E., 2000, 'Capital Market Liberalization, Economic Growth, and Instability', *Development* Vol. 28 (6) pp. *1075-1086.*

Summers, Lawrence, 1999. 'A new framework for multilateral development policy', Remarks to the Council on Foreign Relations, Treasury News March 20, Washington, DC, USA.

U.S. Treasury Department, 2000, *Response to the Report of the International Financial Institution Advisory Commission.* Washington, D.C., USA.

UNCTAD, 1998, *World Investment Report 1998: Trends and Determinants,* Geneva, Switzerland.

UNCTAD, 1999, 'Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI). Characteristics, similarities, complementarities and differences, policy implications and development impact', TD/B/COM.2/EM.6/2, Geneva, 15 April.

UNCTAD, 1999. 'Trends in FDI and Ways and Means of Enhancing FDI Flows to and among developing countries', TD/B/COM.2/21, Geneva, Switzerland.

UNCTAD, 1999. Report of the Expert Meeting on portfolio investment flows and foreign direct investment (held at the Palais des Nations, Geneva June 28-30). Trade and

Development Board Commission on Investment, Technology and related financial issues. TD/B/COM.2/20, 10 August.

United Nations Development Programme (UNDP), 1999. *Human Development Report 1999*, Oxford University Press, New York, NY, USA.

United Nations Development Programme, 2000. *Human Development Report 2000.* Oxford University Press, New York, NY, USA.

United States General Accounting Office (GAO), 2000, *Developing Countries: Debt Relief Initiative for Poor Countries Faces Challenges*, Washington DC, USA.

Upton, Barbara, 2000, *The Multilateral Development Banks: Improved U.S. Leadership*, Center for Strategic and International Studies, Washington DC, USA.

Wade, Robert 1999. 'The Coming Fight over Capital Flows', *Foreign Policy* Winter 1998-1999. Vol. 113.

White, H. and Anderson, E., 2000, 'Growth Versus Distribution: Does The Pattern of Growth Matter?', mimeo, Institute of Development Studies, University of Sussex, Brighton, UK.

World Bank, 1989. 'A Framework for Strategic Choices', Strategic Planning Division, Strategic Planning and Review Department, Washington DC, USA.

World Bank, 1997. *Private Capital Flows to developing countries.* World Bank, Washington DC. USA.

World Bank, 1997. *World Development Report 1997*, Washington, D.C., USA.

World Bank, 1998, *Assessing Aid: What works, what doesn't and why?* World Bank Policy Research Report, Washington, D.C. USA.

World Bank, 2000. *Global Development Finance 2000* (CD-ROM), Washington, DC, USA.

World Bank, 2000. *International Financial Architecture: An Update on the World Bank Group's Role*. Development Committee, March 30, Washington, DC, USA.

World Bank, 2000. *Global Development Finance: Analysis and Summary Tables.* World Bank (CD ROM), Washington DC, USA.

This study was commissioned by the project *Development Financing 2000* within the Swedish Ministry for Foreign Affairs. The purpose of the project is to increase awareness, knowledge and international commitment to a strong, effective and well-funded multilateral system for development.

The study's purpose is to provide a broad strategic framework of key issues affecting the future of the Multilateral Development Banks. Some of the key issues addressed by the study are:

- Key functions for the MDBs as a system in a globalized world
- The need for new products and differentiated pricing
- Division of labour in the international system
- Financing needs of the MDBs

REGERINGSKANSLIET

Ministry for Foreign Affairs of Sweden

S-103 39 Stockholm

Tel: +46-8-405 10 00, Fax: +46-8-723 11 76

Web site: www.utrikes.regeringen.se

A Foresight and Policy Study of the Multilateral Development Banks

Omslag: Rolf Hernegran, Graphium Norstedts Tryckeri